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# An Ex Ante Approach to Excessive State Debt

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# An Ex Ante Approach to Excessive State Debt

## **Abstract**

The recent recession has shone a very public spotlight on the perilous financial conditions of many American states. At the same time, it has renewed academic interest in the question of excessive state debt—its causes and possible cures. Scholars who see risk externalization as a primary driver of systematic overborrowing have proposed bankruptcy legislation for the states as one solution. Such advocates argue that a formal debt-adjustment mechanism could reduce the appeal of federal bailouts and thereby curtail the moral hazard leading to excessive debt. But given the states' unilateral power to set the terms of default, it is hard to see why an opportunistic state would be inclined voluntarily to invoke an ex post debt-adjustment mechanism—and indeed this Article shows that even under existing law states could effectively opt into the federal bankruptcy procedures of Chapter 9 if they so desired. An ex ante approach is needed.

This Article identifies one such ex ante approach, "tax-credit borrowing," and argues that with minimal changes to federal tax policy, this approach could reduce risk externalization more effectively than bankruptcy legislation can. The advantage of tax-credit borrowing in this context stems from its capacity to preclude default by toggling the plaintiff/defendant distinction that lies at the heart of modern sovereign-immunity doctrine. Without a credible threat of default, a state's leverage in bailout negotiations and the concomitant moral hazard would be greatly reduced. But tax-credit borrowing would have important implications for state fiscal policy even if agency problems (rather than risk externalization) better explain state borrowing habits. This Article shows how the availability of risk-free debt could reduce borrowing costs and improve the monitoring of state political actors.

## **Disciplines**

Business Law, Public Responsibility, and Ethics

# AN EX ANTE APPROACH TO EXCESSIVE STATE DEBT

VINCENT S.J. BUCCOLA<sup>†</sup>

## ABSTRACT

*The recent recession has shone a very public spotlight on the perilous financial conditions of many American states. At the same time, it has renewed academic interest in the question of excessive state debt—its causes and possible cures. Scholars who see risk externalization as a primary driver of systematic overborrowing have proposed bankruptcy legislation for the states as one solution. Such advocates argue that a formal debt-adjustment mechanism could reduce the appeal of federal bailouts and thereby curtail the moral hazard leading to excessive debt. But given the states' unilateral power to set the terms of default, it is hard to see why an opportunistic state would be inclined voluntarily to invoke an ex post debt-adjustment mechanism—and indeed this Article shows that even under existing law states could effectively opt into the federal bankruptcy procedures of Chapter 9 if they so desired. An ex ante approach is needed.*

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## TABLE OF CONTENTS

Introduction .....	236
I. The Nature and Significance of Tax-Credit Borrowing .....	243
A. Remedial Law as an Obstacle to Priority Borrowing .....	245
B. Tax-Credit Borrowing as Risk-Free Debt .....	250
C. Practical Obstacles .....	258
1. <i>Insufficient Liquidity in Secondary Markets</i> .....	258
2. <i>Federal Tax Policy</i> .....	260
3. <i>Tradability of Pension Obligations</i> .....	260
II. The Problem of Excessive State Debt .....	261
A. Risk Externalization .....	262
B. Agency Problems .....	267
III. Tax-Credit Borrowing and Risk Externalization .....	269
A. Background: Chapter 9 and the State-Bankruptcy Debate .....	269
B. State Eligibility for Chapter 9 Absent Legislation .....	274
C. Tax-Credit Borrowing as a Solution .....	280
IV. Tax-Credit Borrowing and Agency Problems .....	281
Conclusion .....	284

## INTRODUCTION

Detroit's 2013 petition for Chapter 9<sup>1</sup> bankruptcy relief<sup>2</sup> can be read as the coda to a dramatic yet idiosyncratic tale of economic decline. Challenges from abroad to the domestic automotive industry, rapid depopulation, and questionable leadership tell a remarkable and discomfoting story. But in many respects the financial problems Detroit faces today are similar to, if currently more pronounced than, the troubles confronting many towns and cities across the country. The economic slump following the 2008 housing-market implosion exposed the precarious financial position of many American states too. Declining real-property values and employment levels combined to erode the tax base. At the same time, spending obligations attached to countercyclical welfare programs, such as Medicaid,

1. 11 U.S.C. §§ 901–946 (2012).

2. Declaration of Kevyn D. Orr in Support of City of Detroit, Michigan's Statement of Qualifications Pursuant to Section 109(c) of the Bankruptcy Code, *In re City of Detroit*, 498 B.R. 776 (Bankr. E.D. Mich., filed July 18, 2013) (No. 2:13-bk-53846).

strained what revenue states could raise.<sup>3</sup> The net result has been to underline these states' massive debt obligations, particularly bond and retirement-benefit obligations. Credit-rating agencies have repeatedly downgraded the general-obligation ratings of the most troubled states, including California, Illinois, Michigan, and New Jersey.<sup>4</sup> And commentators have begun to worry about the first wave of state defaults since the 1890s.<sup>5</sup>

Signs of a reviving national economy could lessen some concerns. In June of 2013, for example, the California legislature surprised observers with its first budget surplus in years.<sup>6</sup> Yet the picture is far from sanguine. Public-employee pension funds have been chronically underfunded. Thus, for example, California achieved its "surplus" by underfunding its teachers' pensions to the tune of \$4.5 billion.<sup>7</sup> Experts calculate that pension trust funds in some states, notably Illinois, will be exhausted within the decade.<sup>8</sup> The most troubled states are at best out of the frying pan.

Responding to this predicament, a number of academics and political figures have urged Congress to permit states to restructure or otherwise shed debt through a formal, federal bankruptcy process modeled on Chapter 9 of the Bankruptcy Code. A series of op-eds

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3. Adam J. Levitin, *Fiscal Federalism and the Limits of Bankruptcy*, in WHEN STATES GO BROKE 214, 216–19 (Peter Conti-Brown & David A. Skeel, Jr. eds., 2012); Damon A. Silvers, *Obligations Without the Power to Fund Them*, in WHEN STATES GO BROKE, *supra*, at 40, 45–50.

4. See, e.g., Pamela M. Prah, Adam Rotmil & Stephen C. Fehr, *Infographic: S&P State Credit Ratings, 2001–2014*, PEW CHARITABLE TRUSTS (June 9, 2014), <http://www.pewtrusts.org/en/research-and-analysis/blogs/stateline/2014/06/09/sp-ratings-2014>.

5. Arkansas defaulted on its bond obligations in 1933, the only state to have defaulted since the beginning of the twentieth century. For representative concerns over state default, see, for example, Michael Cooper & Mary Williams Walsh, *Mounting Debts by States Stoke Fears of Crisis*, N.Y. TIMES, Dec. 5, 2010, at A1 (reporting financial analysts' fear that "because many state and local governments have so much debt—several trillion dollars' worth, with much of it off the books and largely hidden from view"—their debt "could overwhelm them in the next few years"); Mark Muro, *Will States Default on Their Debt?*, NEW REPUBLIC (Jan. 18, 2011), <http://www.newrepublic.com/blog/the-avenue/81688/will-states-default-their-debt> ("Look for the unprecedented times and the forced end of business-as-usual, with radical restructurings absolutely necessary.").

6. Jim Christie, *California Governor and Lawmakers Strike Budget Deal*, REUTERS (June 10, 2013, 9:07 PM), available at <http://www.reuters.com/article/2013/06/11/us-california-budget-idUSBRE95A01N20130611>.

7. David Henderson, *California's Phony Budget Surplus*, LIBR. ECON. & LIBERTY (June 1, 2013), [http://econlog.econlib.org/archives/2013/06/californias\\_pho.html](http://econlog.econlib.org/archives/2013/06/californias_pho.html).

8. Olivia S. Mitchell, *Public Pension Pressures in the United States*, in WHEN STATES GO BROKE, *supra* note 3, at 67.

has made the case in the popular press.<sup>9</sup> Meanwhile law reviews have witnessed the growth of what one commentator dubs a “cottage industry” devoted to debating the merits and design of a state-bankruptcy regime.<sup>10</sup>

The state-bankruptcy proposals have an intuitively surprising ambition. Since the pioneering work of Professors Douglas Baird and Thomas Jackson in the 1980s, economically minded scholars have generally understood bankruptcy as a corrective to the familiar collective-action problems attending individual and corporate financial distress—the so-called common-pool and debt-overhang problems.<sup>11</sup> These dynamics are at best attenuated in the public

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9. Jeb Bush & Newt Gingrich, Op-Ed., *Better Off Bankrupt: States Should Have the Option of Bankruptcy Protection to Deal with Their Budget Crises*, L.A. TIMES, Jan. 27, 2011, <http://articles.latimes.com/print/2011/jan/27/opinion/la-oe-gingrich-bankruptcy-20110127> (“Federal bailouts must come to an end. Federal taxpayers in states that balance their budgets should not have to bail out the irresponsible, pandering politicians who cannot balance their budgets. Congress must allow a safe, orderly way under federal bankruptcy law for states to reorganize their finances.”); Grover G. Norquist & Patrick Gleason, *Let States Go Bankrupt*, POLITICO (Dec. 24, 2010, 8:52 AM, updated Dec. 24, 2010, 9:48 AM), <http://www.politico.com/news/stories/1210/46777.html> (“[F]ederal legislation allowing states to file bankruptcy might be the only way to avoid a federal bailout of the most fiscally reckless states in the union.”). These pieces borrowed from David Skeel’s op-ed. proposals. See David Skeel, Op-Ed., *A Bankruptcy Law—Not Bailouts—for the States*, WALL ST. J., Jan. 18, 2011, <http://online.wsj.com/news/articles/SB10001424052748703779704576073522930513118> [hereinafter Skeel, *A Bankruptcy Law*]; David Skeel, *Give Bankruptcy a Chance*, WEEKLY STANDARD (June 29, 2009), <http://www.weeklystandard.com/Content/Public/Articles/000/000/016/658hmvhc.asp> [hereinafter Skeel, *Give Bankruptcy*]; David Skeel, *Give States a Way to Go Bankrupt*, WEEKLY STANDARD (Nov. 29, 2010), [http://www.weeklystandard.com/articles/give-states-way-go-bankrupt\\_518378.html](http://www.weeklystandard.com/articles/give-states-way-go-bankrupt_518378.html) [hereinafter Skeel, *Give States*].

10. Clayton P. Gillette, Commentary, *Bankruptcy and Its By-Products: A Comment on Skeel*, 50 HOUS. L. REV. 1129, 1130 (2013) [hereinafter Gillette, *Bankruptcy By-Products*]. Representative pieces include Anna Gelpern, Commentary, *A Skeptic’s Case for Sovereign Bankruptcy*, 50 HOUS. L. REV. 1095 (2013); Clayton P. Gillette, *Fiscal Federalism, Political Will, and Strategic Use of Municipal Bankruptcy*, 79 U. CHI. L. REV. 281 (2012) [hereinafter Gillette, *Fiscal Federalism*]; Richard M. Hynes, *State Default and Synthetic Bankruptcy*, 87 WASH. L. REV. 657 (2012); Adam J. Levitin, *In Defense of Bailouts*, 99 GEO. L.J. 435 (2011); Stephen L. Schwarcz, *A Minimalist Approach to State “Bankruptcy”*, 59 UCLA L. REV. 322 (2011); David A. Skeel, Jr., Address, *Is Bankruptcy the Answer for Troubled Cities and States?*, 50 HOUS. L. REV. 1063 (2013) [hereinafter Skeel, *Is Bankruptcy*]; David A. Skeel, Jr., *States of Bankruptcy*, 79 U. CHI. L. REV. 677 (2012) [hereinafter Skeel, *States of Bankruptcy*].

11. A common pool refers to a situation where it is in the best interest of each participant, acting alone, to maximize use of a shared asset, even where doing so would reduce the asset’s aggregate value. See, e.g., THOMAS H. JACKSON, THE LOGIC AND LIMITS OF BANKRUPTCY LAW 10–19 (1986); Douglas G. Baird, *The Uneasy Case for Corporate Reorganizations*, 15 J. LEGAL STUD. 127, 132–33 (1986); Thomas H. Jackson, *Bankruptcy, Non-Bankruptcy Entitlements, and the Creditors’ Bargain*, 91 YALE L.J. 857, 864–65 (1982). Debt overhang occurs when existing debt deters new investment because the benefits from new investment will go to existing debtors rather than to new investors. Kenneth Ayotte & David A. Skeel, Jr.,

context, however, in which creditor remedies are closely circumscribed and where states can raise capital by fiat.<sup>12</sup> Rather, proponents of state bankruptcy take aim at what they see as a moral hazard associated with the possibility of a federal bailout.<sup>13</sup>

On this theory, adhered to even by many skeptics of state-bankruptcy legislation,<sup>14</sup> states may systematically overborrow secure in the knowledge that if things get dire enough the national government will come to their rescue. Spillover costs and the risk of contagion associated with a major default all but guarantee assistance; the federal government cannot credibly promise not to intervene. Moral hazard in this context arises not from explicit insurance, but from an expectation that the state will be viewed as “too big to fail.” If the federal apparatus must prop up (apparently) overleveraged banks and insurers, why not overleveraged states? Such, anyway, was Warren Buffett’s reasoning in an interview laying out this view.<sup>15</sup> To the extent a state’s default could infect the broader economy, strategic state actors would likely act as though the federal government were the state’s insurer.

The proponents of a state-bankruptcy regime seek to relieve this dynamic. If states enjoyed a forum, endowed with the majesty of law, in which creditors could be forced to take a haircut in the name of solvency and stability, then perhaps at least the pathetic argument for bailout could be resisted. As one commentator put it, “The appeal of

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*Bankruptcy or Bailouts?*, 35 J. CORP. L. 469, 474 (2010); see generally Stewart C. Myers, *The Determinants of Corporate Borrowing*, 5 J. FIN. ECON. 147 (1977) (explaining how the existence of corporate debt can weaken the corporation’s incentive to undertake good future investments).

12. Anna Gelpern, *Bankruptcy Backwards: The Problem of Quasi-Sovereign Debt*, 121 YALE L.J. 888, 910 (2012); Gillette, *Fiscal Federalism*, *supra* note 10, at 295; Michael W. McConnell & Randal C. Picker, *When Cities Go Broke: A Conceptual Introduction to Municipal Bankruptcy*, 60 U. CHI. L. REV. 425, 429 (1993).

13. See, e.g., Schwarcz, *supra* note 10, at 324. Moral hazard refers to the propensity of an insured actor to take on supraoptimal risk because the insurer will bear some or all of the costs of the risk’s materializing.

14. See Gillette, *Fiscal Federalism*, *supra* note 10, at 312–13 (“Bailouts create moral hazard and impede efforts to impose fiscal discipline on localities. Bailouts violate the underpinnings of fiscal federalism by imposing on nonresidents the costs of decisions made solely by local officials.”); Gelpern, *supra* note 10, at 1113.

15. Jamie McGee & Darrell Preston, *Buffett Says GM Rescue May Mean U.S. Can’t Say No to States*, BLOOMBERG (May 5, 2010, 12:01 AM), <http://www.bloomberg.com/news/2010-05-05/buffett-says-gm-rescue-may-mean-u-s-can-t-say-no-to-states-facing-default.html>.

bankruptcy-for-states is that it would give the federal government a compelling reason to resist the bailout urge.”<sup>16</sup>

Capitol Hill has evidently scotched state-bankruptcy legislation for the time being.<sup>17</sup> Perhaps, one might think, we will never know about the merits of a “Chapter 9 for states.” Yet a fatalistic attitude on this score is unjustified. Although under existing law states are formally ineligible for bankruptcy relief,<sup>18</sup> in practical terms they could, with some creative structuring, make their finances eligible for adjustment in Chapter 9. States could leverage the Bankruptcy Code’s capacious definition of “municipality,” which is broad enough to encompass an instrumentality chartered for the sole purpose of issuing debt.<sup>19</sup>

That states have not made themselves eligible for bankruptcy in this way indicates foundational problems with arguments that a state-bankruptcy regime would alleviate bailout incentives and thus moral hazard. Indeed, state-bankruptcy skeptics have identified these problems as challenges to hypothetical legislation. First, sovereign immunity implies that states do not need federal authorization to adjust debts, which they can effectively discharge or reduce through default.<sup>20</sup> Second, the moral-hazard theory<sup>21</sup> itself suggests that strategic state actors will not voluntarily cede the power to externalize risk, a power that maximizes the joint surplus of the state and its creditors. One is tempted to conclude that voluntary, *ex post* correctives to state moral hazard are doomed for these reasons.

This Article identifies an *ex ante* financing mechanism that could more effectively reduce the moral hazard associated with too-big-to-fail thinking. Specifically, this Article suggests that widespread use of “tax-credit borrowing” (in place of traditional forms of state debt) could decrease the prospect of state defaults. State debt typically constitutes a promise that the treasury will pay a specified sum at a specified future date. This Article proposes recharacterizing some or all of these obligations, be they to a state’s lenders, vendors, or employees. Instead of promising a cash outlay, the state would

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16. Skeel, *Give States*, *supra* note 9.

17. Nicole Bullock, *Lawmakers Resist Bankruptcy for US States*, CNBC (Feb. 15, 2011, 6:45 AM), [www.cnbc.com/id/41595577](http://www.cnbc.com/id/41595577).

18. 11 U.S.C. § 109(a) (2012).

19. See *infra* notes 172–75 and accompanying text.

20. See Hynes, *supra* note 10, at 676–79; Jonathan Rodden, *Market Discipline and U.S. Federalism*, in *WHEN STATES GO BROKE*, *supra* note 3, at 123, 131–32.

21. See Rodden, *supra* note 20, at 124.



promise to allow the holder of a debt instrument to offset her taxes by the amount owed. The state's coffers would feel no effect—one more dollar payable is the same as one less dollar receivable.<sup>22</sup>

The difference is not financial but legal, trading on the plaintiff/defendant distinction at the heart of modern sovereign-immunity doctrine. States can default on traditional debt because creditors lack a remedy. A state wishing to repudiate a vested tax credit, however, can do so only by collecting the taxes at issue. This would require the *state*, rather than the creditors, to invoke judicial process. As a plaintiff, the state would be unable to invoke sovereign immunity; its creditors would be free to defend the tax-underpayment action by invoking the Constitution's Contract Clause. If the threat of default can give states the whip hand in negotiations with the federal government, then tax-credit borrowing could eliminate the moral hazard by curtailing default.

At the outset, I must confess agnosticism about the empirical significance of the moral hazard that state-bankruptcy proponents identify. Their theory is sound enough, to be sure. Risk externalization—the tendency to shift the costs associated with uncertain, bad outcomes—has preoccupied many would-be reformers of corporate, banking, and insurance law, to name only a few subjects. Plainly it is a *plausible* concern. And in looking at recent bailouts around the world, from AIG to Greece, it is hard (for the cynical among us, anyway) not to detect the sure whiff of gamesmanship.

Yet thoughtful observers are not unanimous on this question, one that seems to elude objective measurement.<sup>23</sup> Some have argued

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22. This is mathematically true, but its truth does not necessarily imply that relevant players in the markets and at the polls will think it so. A large and growing literature on tax salience suggests that in some circumstances financially identical obligations are widely thought to bear divergent costs. For an introduction to the literature, see generally David Gamage & Darien Shanske, *Three Essays on Tax Salience: Market Salience and Political Salience*, 65 TAX L. REV. 19 (2011). That said, there are good reasons to think the financial identity of traditional and tax-credit-borrowing arrangements would be clear. First, prices in a competitive market are set by the marginal rather than inframarginal participants. As long as the marginal potential lender sees that a dollar is a dollar, yields will equilibrate except to the extent risk properties differ. Second, the two forms of borrowing are the same with respect to timing and the immediate incidence of the financial burden on the state treasury. To illustrate the intuition, imagine that a charitably minded person wishes to subsidize a shopper's grocery bill. The donor stands at the checkout line and presents the shopper with a choice: he can either have a one-dollar note before paying the cashier, or the donor can pay the cashier directly, reducing the shopper's bill by the same amount. It is hard to imagine the shopper caring; indeed, he would likely find the choice puzzling.

that constitutional taxing and debt restrictions, rather than a coherent externalization strategy, are to blame for the states' current problems.<sup>24</sup> Others posit more generally that subnational governments are simply unresponsive to the subtler incentives of federal fiscal policy.<sup>25</sup> Moreover, any externalization incentive within a jurisdiction is bound to meet opposition from within as well as outside state lines. When financial distress appears on the horizon, creditor coalitions will inevitably exert what influence they can to assure a policy of debt repayment: A federal bailout is never certain and is in any event unlikely to make creditors whole. How this political dynamic plays out in any given case will turn on particulars still obscure after three centuries of political economy. This Article aims not to enter a public-choice debate, but only to note that the extent of states' apparent moral hazard is in doubt (if indeed it makes any sense in this context to speak of the state as a unified whole).

The risk-externalization theory of excessive state debt calls for a straightforward and normatively attractive application of tax-credit borrowing. The question this Article poses (and begins to answer) is, however, more general: what might tax-credit borrowing look like in a world where states are inclined to overborrow? What follows should therefore interest even readers who think state borrowing practices have little to do with risk externalization. For example, the principal competing theories of excessive state debt stem from a standard agency problem: politicians overborrow because they are not effectively monitored. They favor spending on projects for which they can take credit or gain favors, and they are inclined to push costs to the future, long after they leave office. On this view the people affected by a state's long-term financial prospects do a poor job of reining in borrowing. They reward near-term spending and tax-relief initiatives at the expense of future solvency; they are draped in fiscal illusion. Here again the introduction of tax-credit borrowing could have significant consequences for fiscal policy. Certainty of repayment means cheaper debt in the first instance. But such certainty also reduces the incentive to monitor—rather, it *shifts* the monitoring incentive because it shifts the incidence of financial risk

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23. For a discussion of how tax-credit borrowing could shed light on the empirical significance of risk externalization, see *infra* Part II.A.

24. Levitin, *supra* note 3, at 218; Silvers, *supra* note 3, at 50–52.

25. Clayton P. Gillette, *Bondholders and Financially Stressed Municipalities*, 39 FORDHAM URB. L.J. 639, 677 (2012); Richard C. Schragger, *Democracy and Debt*, 121 YALE L.J. 860, 866 (2012).

from creditors to taxpayers and residents. Whether tax-credit borrowing could be a tool for good or ill is thus a question of political economy on which this Article seeks to shed light.

This Article proceeds in four parts. Part I describes the law governing traditional state borrowing practices and explains why states have difficulty creating risk-free or otherwise superpriority debt obligations. It then introduces tax-credit borrowing as a solution to that particular problem of public finance. Parts II through IV consider applications of tax-credit borrowing to the problem of excessive state debt. Part II defines the problem and gives background on the leading explanations. Part III takes up the risk-externalization theory, describing the state-bankruptcy debate and arguing that tax-credit borrowing can better cure moral hazard than debt-adjustment legislation. Part IV discusses how tax-credit borrowing could mitigate agency problems often thought to cause excessive debt.

## I. THE NATURE AND SIGNIFICANCE OF TAX-CREDIT BORROWING

This Article's most modest ambition is to identify a solution to a seemingly intractable problem in public finance: states' inability to issue debt credibly stratified by priority of payment obligation. More specifically, it seeks to identify a mechanism by which states could borrow against risk-free debt obligations.

Prioritized debt structures are ubiquitous in the private sphere. In the business context, for example, a firm wishing to raise cash for current expenditures may simultaneously (or, more typically, iteratively) borrow from some lenders on a secured basis and from others with unsecured bonds or notes.<sup>26</sup> The debtor firm's repayment obligation is owed equally to secured and unsecured creditors, but the secured creditor faces less risk of impairment and therefore charges a lower interest rate. State law permits the secured creditor to foreclose on and sell mortgaged property to satisfy its debt without respect to the effect foreclosure may have on unsecured or otherwise junior

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26. Borrowers are of course not limited to the secured/unsecured dichotomy. Second-lien secured debt and subordinated unsecured debt are staples of corporate finance. Individuals have the same opportunity. A consumer debtor may, for example, use the title to her Porsche as collateral for a secured loan and at the same time borrow on an unsecured basis by swiping her credit card.

creditors.<sup>27</sup> In the event of a bankruptcy filing, the absolute-priority rule ensures that secured claims be paid in full before junior interests receive anything from the estate.<sup>28</sup>

Even the most senior creditor of a business firm faces risk, of course. The collateral may lose value to such a degree that the creditor is impaired notwithstanding her repossession or foreclosure rights. But standard covenants can reduce the risk to something approaching zero. Secured loans often decree a default—and thus accelerate repayment obligations and remedies for nonpayment—if, for example, the debtor's debt-to-assets ratio falls below a specified threshold. The more conservative the ratio, the safer and cheaper the debt is.

Prioritizing obligations can allow a debtor to reduce total borrowing costs.<sup>29</sup> Yet the remedial law applicable to states prevents them from issuing traditional superpriority debt broadly. The states' immunity from enforcement suits impairs their ability to make credible commitments at all—let alone priority commitments. In other words, in addition to paying for the time-value of money and for the risk that assets will be insufficient to cover debt, a state borrower must compensate lenders for the political risk that the state will choose to default and reject a judicial remedy. Thus, in the sovereign context, the issuance of priority obligations affords little or no reduction in borrowing costs (unless backed by collateral that a creditor could practically seize). This Part describes the remedial problem and then introduces the concept of tax-credit borrowing as a commitment device that can create superpriority, risk-free debt.

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27. Article 9 of the Uniform Commercial Code governs repossession of moveable assets. See U.C.C. § 9-601, 9-608–10 (2010). The law of foreclosure on real property varies by jurisdiction, but it is an available remedy in every state.

28. See *RadLAX Gateway Hotel, LLC v. Amalgamated Bank*, 132 S. Ct. 2065, 2070–71 (2012) (analyzing 11 U.S.C. § 1129(b)(2)(a)); *Bank of Am. Nat'l Trust & Sav. Ass'n v. 203 N. LaSalle St. P'Ship*, 526 U.S. 434, 444–49 (1999) (interpreting 11 U.S.C. § 1129(b)); *Case v. L.A. Lumber Prods. Co.*, 308 U.S. 106, 114–16 (1939) (stating that secured creditors come before unsecured creditors in reorganization law).

29. Why exactly this is so remains a longstanding puzzle. See generally Franco Modigliani & Merton H. Miller, *The Cost of Capital, Corporation Finance and the Theory of Investment*, 48 AM. ECON. REV. 261 (1958) (showing that under certain assumptions, investors should be indifferent to the capital structure of a firm). The answer may lie in the diversity of lenders' risk preferences. It may also be a function of variable monitoring costs. See Saul Levmore, *Monitors and Freeriders in Commercial and Corporate Settings*, 92 YALE L.J. 49, 50–59 (1982) (arguing that economies in the monitoring of debtor behavior may explain secured lending).

*A. Remedial Law as an Obstacle to Priority Borrowing*

The states' inability to prioritize debt is a function in the first instance of sovereign immunity. Creditors have long found their attempts to secure payments from the states frustrated in federal court.<sup>30</sup> In the well-known 1890 case of *Hans v. Louisiana*,<sup>31</sup> itself an action seeking payment on a state bond, the Supreme Court interpreted the Eleventh Amendment, and the principles of sovereignty underlying it, to block federal-question jurisdiction over suits against the states by their own citizens.<sup>32</sup> Although *Ex parte Young*<sup>33</sup> soon put sovereign immunity's longevity, or at least its scope, in doubt,<sup>34</sup> the modern Court has consistently held that sovereign immunity bars federal actions seeking money damages from a state's treasury.<sup>35</sup> The picture for creditors is almost as bleak in the state judiciaries. *Alden v. Maine*<sup>36</sup> prevents Congress from subjecting nonconsenting states to private suits for damages in the states' own courts.<sup>37</sup> The states are thus free simply to deny creditors a forum for recovery, and some version of immunity is the norm in every state. One study reports that today forty of the fifty states bar money-damages suits in their own courts, and none consents to damages actions in federal court.<sup>38</sup> Nor can creditors of those states that do allow damages actions rest easy. Legislatures remain free to strip the courts of jurisdiction in anticipation of a default.<sup>39</sup> And enforcement of a judgment could present its own difficulties.<sup>40</sup>

In short, state creditors lack coercive power to enforce a debt owed. They are at the mercy of state fiscal expediency. In practical terms this means that state politicians may legislate debt adjustments as they see fit. Suppose a financially strapped state wished to pay only

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30. See, e.g., *Edelman v. Jordan*, 415 U.S. 651, 667–74 (1974); *Ford Motor Co. v. Dep't of Treasury*, 323 U.S. 459, 464 (1945); *Great N. Life Ins. Co. v. Read*, 322 U.S. 47, 49–52 (1944).

31. *Hans v. Louisiana*, 134 U.S. 1 (1890).

32. *Id.* at 20–21.

33. *Ex parte Young*, 209 U.S. 123 (1908).

34. *Id.* at 149–52.

35. See, e.g., *Va. Office for Prot. & Advocacy v. Stewart*, 131 S. Ct. 1632, 1639 (2011); *Edelman*, 415 U.S. at 667–74. For an extensive treatment of sovereign immunity's doctrinal development, see generally JOHN V. ORTH, *THE JUDICIAL POWER OF THE UNITED STATES: THE ELEVENTH AMENDMENT IN AMERICAN HISTORY* (1991).

36. *Alden v. Maine*, 527 U.S. 706 (1999).

37. *Id.* at 755–56.

38. Gelpert, *supra* note 12, at 901.

39. See *Alden*, 527 U.S. at 750–51.

40. Gelpert, *supra* note 12, at 900.

seventy-five cents on the dollar for a series of bonds due next year. This might be accomplished by reducing the bonds' principal, extending their maturity, or reducing their interest rate. To accomplish this, the state legislature could declare its intention to default and permit holders to exchange the now-worthless paper for new, amended bonds.<sup>41</sup> Alternatively, the state could decline to pay a class of debt outright. In this way the state can unilaterally adjust its debts without creditor consent or any kind of federal imprimatur.

What of state constitutional provisions making certain classes of debt sacrosanct? Many constitutions provide that debts are backed by the state's "full faith and credit."<sup>42</sup> Could this kind of guarantee invalidate legislation aimed at strategic default? It is possible that a governor opposed to default could cite constitutional language of this sort to justify a decision to buck legislative will. To the extent such a governor thought the legislature's repudiation *ultra vires*, he could perhaps pay the state's debts in defiance of legislative repudiation. But this kind of move would be of doubtful validity<sup>43</sup>—and probably unpopular in a repudiating state. Certainly, given the protections of sovereign immunity, it is hard to see how a constitutional right to payment could help creditors in the courts.

In addition to blocking creditor remedies using sovereign immunity, states might also be able to restructure their debt obligations unilaterally by attacking the substantive debts themselves. This might be accomplished through a composition statute setting the

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41. This is not merely a theoretical possibility. In the period following Reconstruction, a number of southern states repudiated bond obligations. At times, their strategy was to declare outstanding instruments invalid, but permit holders to redeem them in exchange for newly issued securities granting less attractive terms. In 1874, for example, Louisiana had bonds outstanding with a face value of \$18,000,000. John Norton Pomeroy, *The Supreme Court and State Repudiation—The Virginia and Louisiana Cases*, 17 AM. L. REV. 684, 699 (1883). Legislators declared that the debts were fraudulent and that the state would not pay. *Id.* In a sort of "compromise," the legislature enacted a law permitting bondholders to exchange their instruments for new "consolidation" bonds worth 60 percent of the outstanding bonds' nominal value. *Id.* at 700. More than two-thirds of creditors tendered their bonds. *Id.* To their chagrin, Louisiana ultimately defaulted on its obligations under the consolidation bonds. *Id.*

42. *E.g.*, ILL. CONST. art. IX, § 9(a); LA. CONST. art. VII, § 6(C); WIS. CONST. art. VIII, § 6, cl. 2(a).

43. Although a governor's powers are a matter of state constitutional law, it is easy to imagine a legislature's decision on this score being final. For example, a legislature might functionally repudiate debt by refusing to appropriate funding sufficient for its service or redemption. Although one can imagine arguments to the contrary, it probably exceeds an executive's authority to raid funds appropriated for one purpose to satisfy his view of obligation toward another.

new terms of repayment.<sup>44</sup> In *Faitoute Iron & Steel Co. v. City of Asbury Park*,<sup>45</sup> the Court upheld a New Jersey composition scheme under which the state altered the maturity and interest rates associated with municipal bonds issued by Asbury Park.<sup>46</sup> During the boom of the 1920s, the city had borrowed extensively to fund capital-intensive improvements on the boardwalk.<sup>47</sup> The reduction in tax revenue associated with the Great Depression, coupled with cost overruns and perhaps shoddy management, meant that the city could not hope to repay its debt.<sup>48</sup> Asbury Park defaulted and was placed under state management akin to receivership.<sup>49</sup> By statute the state's supreme court was permitted to adjust the interest and maturity terms of municipal debt, provided that 85 percent of claimants consented.<sup>50</sup> The court approved such an agreement, and dissenting bondholders brought their case to the federal judiciary.<sup>51</sup> The Supreme Court upheld the regime against a Contract Clause challenge.<sup>52</sup> In the Court's view, although the composition reduced the nominal amount owed on the bonds, it did not impair any practical right enjoyed by the bondholders.<sup>53</sup> The city's promise to pay was a mere "paper right" because the bondholders' sole remedy, mandamus against local officials to compel a tax, had proved historically, and as a practical matter, to be an "empty right to litigate."<sup>54</sup>

Congress quickly abrogated *Faitoute*. States may no longer compose the debts of their municipalities absent the consent of each affected creditor; Chapter 9 is now the only route to adjustment of municipal debt.<sup>55</sup> But *Faitoute*'s rationale would seem to survive intact

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44. For an explanation and defense of such "synthetic" bankruptcy, see Hynes, *supra* note 10, at 686–90. See also George Triantis, *Bankruptcy for the States and by the States*, in WHEN STATES GO BROKE, *supra* note 3, at 237, 243 (arguing that states can and should create their own bankruptcy regimes).

45. *Faitoute Iron & Steel Co. v. City of Asbury Park*, 316 U.S. 502 (1942).

46. *Id.* at 516.

47. *Id.* at 503.

48. *Id.*

49. *Id.* at 505.

50. *Id.* at 504–05.

51. *Id.* at 507.

52. *Id.* at 516.

53. *Id.* at 512–16 ("The Constitution is 'intended to preserve practical and substantial rights, not to maintain theories.'" (quoting *Davis v. Mills*, 194 U.S. 451, 457 (1904))).

54. *Id.* at 510; see McConnell & Picker, *supra* note 12, at 430–33 (generally agreeing with the Court's assessment of the practical value of the mandamus remedy in this context).

55. 11 U.S.C. § 903 (2012) ("[A] State law prescribing a method of composition of indebtedness of such municipality may not bind any creditor that does not consent to such

with respect to a state's authority to compose its own debts. The right to payment from the state treasury is much more precarious, much more in the way of a "paper right," than is the right to payment from a municipality. However limited the value of mandamus might have been in the context of a suit against a municipality, sovereign immunity can preclude a remedy against a state entirely.

The advantage a state could derive from a composition statute analogous to the one in *Faitoute* should not be overstated. Some states' constitutions would seem to preclude the tactic, for example by declaring that debts are to be backed by the state's "full faith and credit."<sup>56</sup> Nor is it clear the courts would sanction an extreme composition statute, were they to hear a challenge. The judgment in *Faitoute* is more than seventy years old, and it rested as much on the acquiescence of a supermajority of impaired creditors, and on the observed reasonableness of the composition in question, as on the emptiness of creditor remedies.<sup>57</sup> In any event, though, sovereign immunity likely means that state composition would be effective whether or not it is substantively constitutional.

The states' unilateral debt-adjustment authority poses a seemingly intractable problem of credible commitment. Apparent workarounds are doubtful for legal and pragmatic reasons. One obvious question is why states do not simply consent to suit in federal court if they wish to convey their seriousness.<sup>58</sup> In short, the answer is that doing so presents an analogous commitment problem. To be sure, states are free to waive their sovereign immunity.<sup>59</sup> But apart from consent predicated on the receipt of federal spending, or where

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composition; and . . . a judgment entered under such a law may not bind a creditor that does not consent to such composition."). The reach of this abrogation is now being tested in Puerto Rico, which recently enacted legislation creating a mechanism for the adjustment of its municipal corporations' debts. *Ley para el Cumplimiento con las Deudas y para la Recuperación de las Corporaciones Públicas de Puerto Rico*, P. del S. 1164, Ley Núm. 71 (June 28, 2014). Puerto Rico contends that § 903 does not extend to the Territory, because Puerto Rico is not a "State" for purposes of determining Chapter 9 eligibility. *See* 11 U.S.C. § 101(52) (2012) ("The term 'State' includes the District of Columbia and Puerto Rico, except for the purpose of defining who may be a debtor under chapter 9 of this title.").

56. *See* sources cited *supra* note 42.

57. *Faitoute*, 316 U.S. at 514.

58. *See* Schwarcz, *supra* note 10, at 334 n.68 ("A review of randomly selected state bond indentures and state statutes revealed no effective waivers by states of sovereign immunity in federal court.").

59. *See, e.g.*, *Lapides v. Bd. of Regents of Univ. Sys. of Ga.*, 535 U.S. 613, 617–18 (2002); *Patsy v. Bd. of Regents of Fla.*, 457 U.S. 496, 516 n.19 (1982); *Clark v. Barnard*, 108 U.S. 436, 447 (1883).



Congress has otherwise abrogated immunity,<sup>60</sup> states appear free to renege on a stated policy of consent.<sup>61</sup> Constitutional amendments could perhaps do the trick—federal courts might ignore a state attorney general’s invocation of sovereign immunity if her state’s constitution flatly prohibited it. But such a significant political change is not likely in the offing.

In limited circumstances, states might structure borrowing transactions to circumvent the immunity problem and mirror secured debt in the private context. A simple model would involve a state pledging and transferring possession of assets as security for repayment. If the state were to default, the creditor could satisfy her claim without judicial assistance. Of course, the utility of such a transaction would be sharply circumscribed by the paucity of government assets amenable to this kind of pledge. It is hard to imagine how a creditor could “take possession” of state highways, parkland, or, for that matter, the capitol building. A more sophisticated model might resemble the sale-leaseback transactions into which some states have in fact entered in recent years.<sup>62</sup> Even here, though, the scope of a state’s borrowing capacity is quite limited. The public-trust doctrine prohibits the sale of many state assets,<sup>63</sup> and it is not at all clear that a creditor holding title could call

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60. For a doctrinal overview of Congress’s abrogation authority, see Rebecca E. Zietlow, *Federalism’s Paradox: The Spending Power and Waiver of Sovereign Immunity*, 37 WAKE FOREST L. REV. 141, 182–89 (2002). But note that Zietlow’s discussion predates *Central Virginia Community College v. Katz*, 546 U.S. 356 (2006), in which the Supreme Court held that Congress may abrogate state sovereign immunity via its power to make “uniform Laws on the subject of Bankruptcies,” U.S. CONST. art. I, § 8, cl. 4. *Cent. Va. Cmty. Coll. v. Katz*, 546 U.S. 356, 378–79 (2006).

61. See *Beers v. Arkansas*, 61 U.S. (20 How.) 527, 529 (1858) (holding that a state could withdraw statutory consent to be sued on a defaulted bond); see also *Iowa Tribe of Kan. & Neb. v. Salazar*, 607 F.3d 1225, 1235 (10th Cir. 2010) (“The logic of *Beers* has withstood the test of time.”).

62. See Cindy Holden, *Calif. Governor Brown Cancels Sale of State Properties*, CAL. NEWswire (Feb. 10, 2011), [http://californianewswire.com/2011/02/10/CNW8510\\_000915.php](http://californianewswire.com/2011/02/10/CNW8510_000915.php) (discussing California’s scuttled sale-leaseback proposal); Jennifer Steinhauer, *In Need of Cash, Arizona Puts Offices on Sale*, N.Y. TIMES, Sept. 25, 2009, at A16 (discussing Arizona’s current sale-leaseback regime). In a sale-leaseback transaction, the owner of a valuable asset sells the asset for a lump-sum payment, but continues in possession by leasing back the asset from the buyer. The up-front infusion of cash to the seller, coupled with a periodic payment obligation by the seller, resembles in many respects a traditional loan. See Ronald A. Morris, *Sale-Leaseback Transactions of Real Property—A Proposal*, 30 TAX LAW. 701, 701 (1977) (describing some versions of the sale-leaseback as “disguised loans”).

63. *Ill. Cent. R.R. v. Illinois*, 146 U.S. 387, 453 (1892) (“The State can no more abdicate its trust over property in which the whole people are interested . . . than it can abdicate its police powers in the administration of government and the preservation of the peace.”).

on judicial assistance to evict government tenants or public users—or that a creditor would want to put himself in the position of having to do so. Moreover, structured transactions carry significant transaction costs and appeal to a relatively narrow lender market. They raise difficult problems of valuation and therefore graft.<sup>64</sup>

*B. Tax-Credit Borrowing as Risk-Free Debt*

This Article introduces tax-credit borrowing as a mechanism by which states can circumvent sovereign immunity and create risk-free debt. The most straightforward example of what I have in mind is the tax-credit bond. A tax-credit bond is identical in most respects to a traditional bond. In exchange for an investor's up-front contribution, the state promises to repay principal plus a stated interest rate at the bond's maturity. Maturity and interest rates are determined by market conditions and state and investor preferences. Depending on the bond's terms, repayment can be made periodically, with so-called coupon payments, or can be made in a lump sum at maturity. The bonds are freely alienable, and a vigorous secondary market may emerge to reduce the transaction costs of transfer and therefore the cost of borrowing.

The lone difference is the form of the state's repayment. A traditional bond is a demand on the treasury to cut a check for the specified amount at maturity (or periodically, in the case of a coupon-bearing bond). A tax-credit bond, by contrast, entitles the holder to deduct the agreed amount from her tax bill. Imagine a traditional bond purchased today for \$100. It represents a promise by the state to pay \$120 in ten years' time. In a decade, the holder—who may or may not have been the initial purchaser—may redeem the bond for a check. The \$120 payment can be understood as the return of \$100 in principal and \$20 of interest, itself comprising a combination of the time-value of \$100 and the risk to the holder of the state's default. A corresponding tax-credit bond entitles the holder not to a check, but to an offset of \$120 to the taxes and fees she would otherwise owe the state.<sup>65</sup>

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64. For another variation on the theme, see Julie A. Roin, *Privatization and the Sale of Tax Revenues*, 95 MINN. L. REV. 1965, 2002–06 (2011).

65. I use this figure by way of illustration only. In practice, the amount a state would pay on a \$100 tax-credit bond would be less than on a traditional bond of the same denomination. See *infra* note 71 and accompanying text.

Tax-credit bonds have been little used in American history, but they have some precedent. During the Civil War, West Virginia was created out of the northwestern third of what was then the Commonwealth of Virginia.<sup>66</sup> The Old Dominion was relieved of its war debt, but was still obliged on \$30,000,000 in bonds it had issued to fund general improvements. After the War, the Virginians held that West Virginia should assume a share of the debt proportional to its land mass.<sup>67</sup> To effect their vision, the legislature enacted the Funding Act of 1871.<sup>68</sup> The Act authorized bondholders to redeem their bonds for two newly issued instruments: (1) a certificate entitling the holder to a share of any settlement with West Virginia (representing one-third of the initial bond's nominal value), and (2) a newly issued Virginia bond (representing two-thirds of the initial bond's value).<sup>69</sup> To alleviate fear of repudiation, and thus encourage redemption on its terms, the Commonwealth allowed the coupons associated with its replacement bonds to be set off against the holder's taxes. In the language of the statute, the coupons were made "receivable at and after maturity for all taxes, debts, dues, and demands due the state."<sup>70</sup> Under Virginia's scheme, only the coupons (and not the principal) could be used to offset a holder's tax liability. But the intuition underlying the offset could be generalized to extend to principal.

At least since the mid-1990s, federal legislation has also seen a tax-credit borrowing scheme put to use, although in a different context and for a quite different purpose than this Article advocates. In 1997, Congress authorized state and local governments to issue \$400,000,000 per year of what it dubbed "qualified zone academy bonds" (QZABs).<sup>71</sup> These QZABs, which granted the bearer an offset to her federal taxes, could be issued to support infrastructure development and other spending on presecondary schools for children of low-income families.<sup>72</sup> The details are unimportant here.

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66. For a fuller account of the history of Virginia's tax-credit-borrowing plan, see John V. Orth, *The Interpretation of the Eleventh Amendment, 1798–1908: A Case Study of Judicial Power*, 1983 U. ILL. L. REV. 423, 439–47 (1983); Pomeroy, *supra* note 41, at 694–99.

67. Orth, *supra* note 66, at 439.

68. Funding Act of 1871, ch. 282, 1870–71 Va. Acts 378.

69. *Id.* §§ 2–3.

70. *Id.* § 2. The very next year, Virginia did in fact try to repudiate the tax-credit coupons. For more on that, see *infra* notes 89–102 and accompanying text.

71. See Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 1397E, 111 Stat. 788, 821–24 (1997) (codified at 26 U.S.C. § 1397E).

72. *Id.*

The point is that these tax-credit bonds were employed as a federal subsidy of congressionally preferred state and local activities. Following the QZABs came a series of statutes authorizing the issuance of the following tax-credit bonds to subsidize congressionally favored activities: Clean Renewable Energy Bonds,<sup>73</sup> Gulf Tax Credit Bonds,<sup>74</sup> Qualified Forestry Conservation Bonds,<sup>75</sup> Qualified Energy Conservation Bonds,<sup>76</sup> Midwestern Disaster Area Bonds,<sup>77</sup> and, most recently, under the American Recovery and Reinvestment Act of 2009, Qualified School Construction Bonds, Build America Bonds, and Recovery Zone Economic Development Bonds.<sup>78</sup>

The recent federal incarnations of tax-credit borrowing suggest that investors would be receptive to tax-credit bonds at the state level, à la the Virginia prototype. Proceeds from their sale would not be earmarked for particular objects of federal largesse, but could be used for general state purposes.

The logic of using tax-credit bonds to create superpriority, risk-free debt stems from the Supreme Court's understanding of sovereign immunity. In particular, it relies on the procedural distinction between plaintiff and defendant. The courts will not hear a private plaintiff's claim for damages against a state,<sup>79</sup> but they will reject a state's claim against a private party according to the merits of the defense. This is because sovereign immunity goes to the availability of a remedy, not the existence of a substantive right.<sup>80</sup> To realists it is

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73. Energy Policy Act of 2005, Pub. L. No. 109-58, § 1303, 119 Stat. 594, 992–96 (2005) (codified at 26 U.S.C. § 54); Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, § 107, 122 Stat. 3765, 3817–19 (2008) (codified at 26 U.S.C. § 54C).

74. Gulf Opportunity Zone Act of 2005, Pub. L. No. 109-135, § 15316, 122 Stat. 2577, 2589–93 (2005) (codified at 26 U.S.C. § 54B).

75. Food, Conservation, and Energy Act of 2008, Pub. L. No. 110-246, § 301, 122 Stat. 1651, 2271–74 (2008) (codified at 26 U.S.C. § 54D).

76. *Id.* § 301, 122 Stat. at 3841–44.

77. *Id.* § 702, 122 Stat. at 3912–18.

78. American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, §§ 1521, 1531, 1400U-2, 123 Stat. 115, 349–50 (2009) (codified at 26 U.S.C. § 1400U-2).

79. *Edelman v. Jordan*, 415 U.S. 651, 667–74 (1974).

80. This principle was, for example, at the center of the decision in *Ex parte Young*, 209 U.S. 123, 149 (1908) (“The question that arises is whether there is a remedy that the parties interested may resort to, by going into a Federal court of equity, in a case involving a violation of the Federal Constitution . . .”). For a thorough explanation of the decision's logic, see John Harrison, *Ex Parte Young*, 60 STAN. L. REV. 989, 996 (2008) (“But while the State was for practical purposes a party, it was not so in a way that violated the principle of sovereign immunity. Because the plaintiffs sought an anti-suit injunction that would enforce a defense against the state, the suit in which Minnesota was in substance a party was also one in which Minnesota was in substance the plaintiff and the railroads were the defendants. Asserting a

something of a puzzle why permitting a claim is more offensive to a state's dignity and sovereignty than is sustaining a defense. But doctrinally the difference is critical. When a state invokes the courts to resolve its claims against a private party, the defendant is justified in raising any defense she would otherwise have on the merits.

For the holder of a traditional bond, the remedy against a recalcitrant state is the very suit for money damages that sovereign immunity blocks. Redeeming a tax-credit bond, on the other hand, requires no judicial aid. All the tax-credit bondholder must do is claim the bond's value as an offset to taxes otherwise owed. If the issuing state wished to repudiate its obligation, it would need to sue the holder for underpayment of taxes.<sup>81</sup> This suit would grant the holder a judicial forum in which she could assert her right to the offset as a matter of contract.

In court, the redeemer would have a straightforward defense. The tax-credit bond represents a binding contract that the state may not impair consistent with the Contract Clause.<sup>82</sup> In this setting the judgment in *Faitoute* is inapplicable. *Faitoute* was premised on the Justices' conclusion that in practical terms, the bondholders were in a better position after "impairment" than they would have been absent New Jersey's legislative action.<sup>83</sup> The bondholders enjoyed only a "paper" right to relief.<sup>84</sup> And the price of the relevant bonds had indeed increased after the state altered their terms.<sup>85</sup> Thus, in the Justices' view, the bondholders had little to complain about. In this

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defense against a government does not offend its sovereign immunity."); *id.* at 1000 ("The railroads in Perkins were thus using a familiar mode of proceeding by which a potential defendant at law could sue in equity and present a legal position that would be a defense at law. Because their position was a defense, not an affirmative claim on the State of Minnesota, a court could grant relief without offending sovereign immunity.").

81. *Cf.* U.S. CONST. amend. XIV, § 1 (forbidding the taking of property without "due process of law").

82. *See* U.S. CONST. art. I, § 10, cl. 1 (providing that "No State shall . . . pass any . . . Law impairing the Obligation of Contracts"). The federal nature of the Contract Clause defense supplies the Supreme Court with jurisdiction to review any state court decision rejecting it. *See* 28 U.S.C. § 1257(a) (2012) ("Final judgments or decrees rendered by the highest court of a State in which a decision could be had, may be reviewed by the Supreme Court by writ of certiorari where . . . the validity of a statute of any State is drawn in question on the ground of its being repugnant to the Constitution, treaties, or laws of the United States . . ."). Thus, even if the state were to sue the redeemer in a favorable tribunal—before, say, elected judges sharing the legislature's view of the political merits of repudiation—the redeemer could ultimately find redress in federal court.

83. *Faitoute Iron & Steel Co. v. City of Asbury Park*, 316 U.S. 502, 515–16 (1942).

84. *Id.* at 516.

85. *Id.* at 513.

sense *Faitoute* can be read to validate parties' pragmatic resolution of a well-known holdout problem in multilateral restructurings. Perhaps the decision could even support a state's unilateral restructuring of *traditional* debt obligations, were the case somehow to reach federal court.<sup>86</sup>

But the situation is quite different in the case of a state wishing to repudiate a tax-credit bond. The holder of such a bond enjoys more than a "paper" right. Her right to payment, in the form of an offset, is self-executing upon redemption. Any attempt by the state to shortchange the bondholder would represent a practical as well as theoretical impairment.<sup>87</sup> The skepticism with which the Court has generally viewed state attempts to alter their own contracts would seem paramount. A quarter century after *Faitoute*, for example, the Justices neatly summarized the vision animating Contract Clause jurisprudence in this domain: a state "cannot refuse to meet its legitimate financial obligations simply because it would prefer to spend the money to promote the public good than the private welfare of its creditors."<sup>88</sup>

This understanding of sovereign immunity's implications for tax-credit borrowing was put to the test, and confirmed, when Virginia sought to repudiate its tax-credit coupons in the late nineteenth century. Shortly after Virginia enacted the Funding Act of 1871,<sup>89</sup> a group of politicians called the "Readjusters" came to power in Richmond.<sup>90</sup> The Readjusters sought to repudiate the tax-credit coupons issued to resolve Virginia's antebellum debts.<sup>91</sup> They enacted a series of laws, known as "coupon killers," that aimed to destroy the financial value of the Commonwealth's obligations, if not the

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86. Such anyway is the supposition of Hynes, *supra* note 10, at 681–82.

87. One qualification is worth noting. Although a state cannot default directly, clever legislators might seek to do so underhandedly. Rather than deny the effect of the bond itself, the state could impose a separate tax on bondholders or those who redeem bonds. This would practically cancel the bonds' effectiveness. The courts might be expected to lump such legislation together with the bond promise and hold it void under the Contract Clause. But as a matter of prudence, tax-credit bonds could include a promise by the state not to impose a discriminatory tax on account of the holder's possession or redemption. This sort of promise would itself form part of the "Obligation of Contract[]" beyond the state's power to impair. U.S. CONST. art. I, § 10, cl. 1.

88. U.S. Trust Co. of N.Y. v. New Jersey, 431 U.S. 1, 29 (1977).

89. See *supra* notes 68–70 and accompanying text.

90. Orth, *supra* note 66, at 440–41.

91. *Id.*

obligations themselves.<sup>92</sup> The most prominent and direct effort was a statute barring tax collectors from accepting the coupons in payment of taxes.<sup>93</sup> The act declared that only gold, silver, U.S. Treasury notes, and national-bank notes would be receivable in payment of debts owed to the Commonwealth.<sup>94</sup>

The validity of this attempt at repudiation came to a head in the Supreme Court in 1885, in what are known as the *Virginia Coupon Cases*.<sup>95</sup> The basic fact pattern of these cases is simple enough. A bondholder tendered coupons to the taxman and was rebuffed.<sup>96</sup> The tax collector then levied on the bondholder's assets for underpayment, and this decision set the stage for an action in detinue by the bondholder.<sup>97</sup> The merits of the detinue action turned on whether the bondholder was in fact delinquent in paying his taxes.<sup>98</sup> The Court held, first, that federal jurisdiction existed because the actions were not suits against the state for purposes of sovereign immunity;<sup>99</sup> and, second, that the Constitution invalidated Virginia's law purporting to strip the coupons of their value as tax credit.<sup>100</sup> Whatever a state's machinations, the Court insisted that a bond permitting the holder to offset taxes would be enforced:

The contract with Virginia was not only that the coupons should be received in payment of taxes, but, by necessary implication, that the tax-payer making such a tender should not be molested further, as though he were a delinquent, and that for every illegal attempt subsequently to enforce the collection of the tax, by the seizure of property, he should have remedies of the law in force when the contract was made, for redress, or others equally effective.<sup>101</sup>

The *Coupon Cases* did not end Virginia's attempts to repudiate its tax-credit obligations. But in each instance, before and after *Hans*,

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92. For a discussion of Virginia's attempts to repudiate, see *id.* at 439–47.

93. *Id.* at 440.

94. *Id.* at 442.

95. *Virginia Coupon Cases*, 114 U.S. 269 (1885). For an account of legal wrangling over the Virginia scheme before and after the *Coupon Cases*, see Orth, *supra* note 66, at 439–47.

96. *Virginia Coupon Cases*, 114 U.S. at 273.

97. *Id.*

98. *Id.* at 308.

99. *Id.* at 288.

100. *Id.* at 303–04.

101. *Id.*

the Supreme Court held the line.<sup>102</sup> For purposes of sovereign immunity, tax-credit borrowing works differently from traditional modes of state borrowing.

Thoughtful readers might question whether the result in the *Coupon Cases* would hold today, eighty years after *Home Building & Loan Ass'n v. Blaisdell*<sup>103</sup> held that the financial emergency associated with the Great Depression justified state interference with contractual obligations.<sup>104</sup> But although the cases following *Blaisdell* have undoubtedly empowered states to interfere with contracts to a greater extent than they could have in the nineteenth century, little in the development of Contract Clause jurisprudence would seem to undermine the *Coupon Cases*. The Supreme Court has repeatedly held that state attempts to impair contracts to which they themselves are a party should be viewed skeptically.<sup>105</sup>

Thus, tax-credit borrowing has the capacity to create something approaching risk-free debt. In the first analysis, the superior credibility of tax-credit borrowing can reduce a state's borrowing costs. Return to the example presented above: a bond selling for \$100 and obliging the state to pay \$120 in ten years' time. The nominal \$20 benefit to the lender represents the sum of the time-value of the lender's money and a premium corresponding to the presumed risk of the state's default. Suppose the time-value component came to \$18.

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102. One contemporary account summarized the controversy and the line of cases before and after 1885 this way:

New bonds were issued, the State contracting that the coupons annexed should be receivable for all taxes. For twenty-seven years this legislation has been upheld, except as to one sort of tax, which under the Constitution of Virginia was payable only in specie. But during all that time the legislature has done its best to impair the State's agreement. A statute was passed in 1887 providing that only gold, silver, United States treasury notes, and national bank notes, were receivable for taxes; and by virtue of this statute the present plaintiff was refused relief when he took the proper steps to obtain credit, in payment of taxes, for the coupons which he held. The highest court of the State held the entire coupon agreement unconstitutional, the whole vitiated by the part which was formerly held invalid. It was urged that the Supreme Court could not review this decision; but the court has taken the other view, reversed the judgment of the Virginia court, held the funding contract valid, and decided that it is impaired by the later statute.

Note, *Another Virginia Coupon Case*, 12 HARV. L. REV. 421, 421 (1899); see David P. Currie, *Sovereign Immunity and Suits Against Government Officers*, 1984 SUP. CT. REV. 149, 152-54 (1984); Orth, *supra* note 66, at 439-47 (summarizing the *Virginia Coupon Cases*).

103. *Home Building & Loan Ass'n v. Blaisdell*, 290 U.S. 398 (1934).

104. *Id.* at 437.

105. *Keystone Bituminous Coal Ass'n v. DeBenedictis*, 480 U.S. 470, 505 (1987); *U.S. Trust Co. of N.Y. v. New Jersey*, 431 U.S. 1, 29 (1977); see also Brenner M. Fissell, Note, *The Dual Standard of Review in Contracts Clause Jurisprudence*, 101 GEO. L.J. 1089, 1091-93 (2013) (describing the "stricter standard" applied to self-interested states).



(That is, an analogous U.S. Treasury bond, usually thought to approximate risk-free debt, would pay \$118.) With a tax-credit bond the default premium would shrink to something approaching zero. To raise \$100 today, holding all else equal, the state would need to promise only \$118 in a decade rather than \$120.

To capture this intuition, it may be helpful to think of tax-credit borrowing as a species of the “toggling” transactions that permeate commercial relationships. The logic of tax-credit borrowing is to increase the value of a substantive promise—the obligation to repay—by inverting traditional procedural roles to enhance the promisee’s certainty. It is a way for parties to opt out of seemingly fixed legal rules of procedure in order to maximize their joint surplus.

The ancient institution of the pawn shop is a good illustration of this kind of toggling. *X* wants to borrow from *Y* and is willing to pay a competitive interest rate. *X* is trustworthy, but his trustworthiness is not observable to *Y*. *Y* consults her lawyer and learns that recovery in the event of *X*’s breach is costly. If *X* defaults, *Y* must file an action, obtain a judgment (by default or otherwise), find *X*’s assets, and then levy upon them. Execution may prove too expensive even assuming that *X* has assets. *X*, too, knows that legal process may not be worth the candle to *Y*, and his knowledge reduces his credibility even further in *Y*’s eyes. The expense of civil procedure threatens to prevent *X* from demonstrating his credibility; thus, collateral is born. *X* gives *Y* possession of his prized guitar. Now, in case of default, *Y* need not resort to costly procedures that both parties know will have little if any net value to her. She may simply foreclose. If there is a dispute about *X*’s right to the guitar, *X* must now sue *Y*. The toggle is complete.

Tax-credit borrowing has the capacity to reduce borrowing costs just as pawning does. Its broader significance for state fiscal policy turns, however, on the specifics of its use and on the dynamics of state political economy. Tax-credit borrowing reduces the cost of debt because it precludes default. This does not mean it precludes financial distress. Rather, it shifts the incidence of distress away from the creditor and toward a state’s other constituents. Whether such a shift is normatively preferable depends on, among other things, its expected effects on state financial decisions—states’ borrowing as well as taxing and spending policies.

### C. *Practical Obstacles*

The limited American experience with tax-credit borrowing suggests that it is a viable form of financing state expenditures, at least on a small scale. But it is fair to ask whether the scope of tax-credit borrowing could ever be wide enough to have a significant impact on a state's political economy; and, if it could, why tax-credit borrowing has been so rare historically. This Part considers three of the keenest practical objections: insufficient liquidity in secondary markets, federal tax policy, and the tradability of pension obligations.

1. *Insufficient Liquidity in Secondary Markets.* One criticism of tax-credit borrowing is that the secondary market for tax credits may not be robust enough to support large issuances of tax-credit bonds. A secondary market is critical. There is no particular reason to think that the initial buyers of a state's tax credits will themselves be able to use all of the offset rights they receive in exchange for lending. A creditor may not expect her future tax bills to exceed the face value of her offsets. She might expect little future income, for example; she might not own much taxable property; she might move to a different state. Surely the prospect that credits would go to waste would undermine lenders' incentive to accept an offset right in lieu of cash.

Secondary markets in traditional state and municipal bonds are highly liquid and efficient. Even in 1972, William Staats, of the Federal Reserve Bank of Philadelphia, was able to write that "[c]ommunications networks enable sellers to exhibit bonds throughout the Nation in less than 3 hours. Large or small blocks of bonds of various maturities—whether issued by well-known or quite obscure government entities—may be sold through the secondary market . . . ."<sup>106</sup> Since then, transaction costs have only diminished.<sup>107</sup> But unlike traditional bonds, tax-credit bonds hold intrinsic value only to the extent that market participants expect to owe taxes to the issuing state. Those who expect to pay such taxes will value a tax-credit bond at just below face value at the time of maturity, but such

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106. William F. Staats, *The Secondary Market for State and Local Government Bonds*, in 3 REAPPRAISAL OF THE FEDERAL RESERVE DISCOUNT MECHANISM 3 (1972), available at [http://fraser.stlouisfed.org/docs/historical/federal%20reserve%20history/discountmech/bog\\_reappraisal\\_discount\\_197108\\_vol3.pdf](http://fraser.stlouisfed.org/docs/historical/federal%20reserve%20history/discountmech/bog_reappraisal_discount_197108_vol3.pdf).

107. See Lawrence E. Harris & Michael S. Piwowar, *Secondary Trading Costs in the Municipal Bond Market*, 61 J. FIN. 1361, 1363–64 (2006) (noting that municipal-bond trading may be more efficient because it is not subject to particular trading hours and because web-based trading has become prevalent).

taxpayers represent only a fraction of debt-market participants. Viable secondary markets for the tax-credit bonds of the most populous states are sure to develop. But what about markets for the bonds of low-population states with small tax bases, such as Wyoming or Alaska?

There are at least two plausible lines of response. The first is convertibility. A state could issue bonds promising to pay a specified amount from the state treasury, but granting the holder an option to convert the obligation into a tax credit. This was the approach Virginia took with its tax-credit coupons in the nineteenth century.<sup>108</sup> The value of the option to convert—that is, the discount at which tax-credit bonds trade relative to traditional bonds—would represent the market’s view of the expected cost of repudiation to the traditional bondholder. For an especially solvent and “trustworthy” state, the option would be worth very little: the difference between tax-credit borrowing and traditional borrowing would be negligible. In other words, debt-market participants would value convertible instruments much as they would any other bond in financially stable times. Only in periods of financial distress would the pool of willing buyers shrink.<sup>109</sup> But to the extent tax-credit borrowing can be expected to reduce the ratio of a state’s borrowing to revenue,<sup>110</sup> the process of issuing these bonds could itself mitigate the liquidity problem.

Alternatively (or additionally), smaller-population states might consider an interstate compact to develop a nationwide secondary market. To illustrate, Oregon could promise to honor the tax credits associated with bonds issued by New Jersey. The states would then net out their mutual obligations at an agreed date. This kind of reciprocity agreement would be enforceable in federal court—the federal judicial power extends “to Controversies between two or more States.”<sup>111</sup> After all, the right sought to be enforced would be a

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108. See *supra* notes 66–70 and accompanying text.

109. As the risk of repudiation increases, so too does the probability that a holder will opt to convert. It is the act of conversion—or, rather, the likelihood of conversion—that could drive investors out of the market for these bonds. Ironically, to the extent a viable secondary market could be sustained, it is precisely during periods of financial distress that the spread between a traditional bond and a convertible bond will be greatest.

110. See *infra* notes 192–95 and accompanying text.

111. U.S. CONST. art. III, § 2. Moreover, an action to settle up would not seem to implicate *New Hampshire v. Louisiana*, 108 U.S. 76, 88–91 (1883), which holds that the Eleventh Amendment bars a debt action by one state against another where the plaintiff state seeks to enforce a right properly belonging to its citizens.

right of the plaintiff state in the first instance, not one derived from or assigned by one of its citizens.

2. *Federal Tax Policy.* In some measure, federal legislation is probably needed to spur tax-credit borrowing. At a minimum, the Tax Code would need to be amended to undo what is in effect a relative subsidy of traditional bond borrowing. Section 103 of the Tax Code excludes from gross income the interest a taxpayer earns on most state and municipal bonds.<sup>112</sup> No corresponding provision excludes the interest “income” a tax-credit bond provides in the form of reduced tax liability. This means that the holder of a traditional bond receives more after-tax benefit than does the holder of an otherwise identical tax-credit bond.<sup>113</sup> To achieve parity under the existing regime and so as to attract investor interest, states would have to offer a higher rate of return on tax-credit bonds, something they plainly have no interest in doing.<sup>114</sup>

3. *Tradability of Pension Obligations.* A related obstacle turns on the realistic scope of tax-credit borrowing. It would be easy enough to replace traditional bonds with tax-credit bonds; the plausibility of that change should not provoke much quarrel. But, a critic might say, bonds comprise only a part of state borrowing.<sup>115</sup> States “borrow” far more from workers, the repayment obligations taking the form of pension and other retirement benefits.<sup>116</sup> Unlike with bonds, the extent of the state’s pension obligation to any particular employee depends on a host of factors not easily determined until that employee retires. Seniority, peak salary, age at

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112. 26 U.S.C. § 103 (2012).

113. Issuing convertible instruments would reduce the tax disadvantage imposed by § 103 because, when the issuing state is financially healthy, bondholders can be expected simply to receive interest payments as they do with respect to a traditional bond.

114. At an assumed tax rate of 35 percent, the after-tax yield of a traditional bond is more than 50 percent greater than that of a nominally identical tax-credit bond. To attract investors to the tax-credit bond under the current regime, states would have to offer a correspondingly higher interest rate.

115. See ANDREW ANG & RICHARD C. GREEN, LOWERING BORROWING COSTS FOR STATES AND MUNICIPALITIES THROUGH COMMONMUNI 33 (2011), available at [https://www0.gsb.columbia.edu/faculty/aang/papers/THP%20ANG-GREEN%20DiscusPape\\_Feb2011.pdf](https://www0.gsb.columbia.edu/faculty/aang/papers/THP%20ANG-GREEN%20DiscusPape_Feb2011.pdf) (“Assets in state pension plans total less than \$2.0 trillion at the same date and, thus, Novy-Marx and Rauh estimate the underfunding of state pension plans to be approximately \$3.2 trillion. In comparison, the outstanding publicly traded debt issued by states is approximately only \$1 trillion.”).

116. See, e.g., Skeel, *Is Bankruptcy*, *supra* note 10, at 1072–73.

retirement, and other uncertain determinants mean that the state's debt is indefinite in the year that credit (that is, labor) is supplied. No obviously fungible instrument can be issued to, say, a twenty-five-year-old employee. At retirement, to be sure, the state could issue certificates specifying the periodic (convertible?) tax credit to which the retiree is entitled; *these* would seem amenable to trade. But a potential difficulty arises if, by the time of an employee's retirement, the obligor state faces financial difficulty and refuses to issue the certificate to which the employee is entitled.

Whether this is a real problem turns on the propriety of a mandamus remedy.<sup>117</sup> In one sense, a mandamus petition for the issuance of a pension certificate could be thought to aim directly at the state's treasury in a manner that sovereign immunity precludes. The reason for the petition is of course to deprive the state of revenue. Yet this is probably not the most persuasive way to understand such a remedy.<sup>118</sup> Mandamus would not formally turn on an entitlement to the state's funds. It would rather seek to require a public official to deliver documentation of a right—the right to a specific pension amount—that is not itself questioned.<sup>119</sup>

## II. THE PROBLEM OF EXCESSIVE STATE DEBT

Many states today are in the red, and by no small amount. Depending on one's assumptions, pension shortfalls alone account for between roughly one and three trillion dollars of debt.<sup>120</sup> The share of the GDP devoted to servicing current obligations is growing.<sup>121</sup> One should not fall prey to hindsight bias and conclude in every case of financial distress that the level of borrowing was superoptimal when viewed *ex ante*. The world is probabilistic, and sometimes debt

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117. For a discussion of the effect of sovereign immunity on the feasibility of a mandamus remedy against the state, see *supra* Part I.A.

118. See *Edelman v. Jordan*, 415 U.S. 651, 667 (1974) (explaining that a suit for injunctive relief against a state actor is not barred simply because the relief will have an effect on the state treasury).

119. See *Marbury v. Madison*, 5 U.S. (1 Cranch) 137, 167–70 (1803) (holding that mandamus against a state actor is an appropriate remedy, although not within the Supreme Court's original jurisdiction, for a state actor's refusal to deliver documentation of petitioner's legal right).

120. See, e.g., Robert Novy-Marx & Joshua Rauh, *Public Pension Promises: How Big Are They and What Are They Worth?*, 66 J. FIN. 1211, 1213 (2011) (reporting aggregate underfunding of accrued pension liabilities, as of June 2009, at between \$1.26 trillion and \$2.49 trillion); Mary Williams Walsh, *Ratings Service Finds Pension Shortfall*, N.Y. TIMES, June 28, 2013, at B1 (reporting an estimated \$980 billion shortfall).

121. For a summary, see Cooper & Walsh, *supra* note 5.

burdens that seem reasonable when incurred turn out to be unsustainable. But there is little doubt that in recent decades some states have borrowed, and are now borrowing, far too much.

Appropriate terminology should be used here. How much debt is “just right” depends on deeply contested normative views of government’s role, the appropriate discount rate to apply to the future, and similar factors. Ultimately the standard one chooses is of little importance to this Article’s central themes. But it may be worth positing a definition of excessive debt that will focus some of the analysis that follows. I have in mind debt that results in socially wasteful spending—projects that the polity, however defined, values at less than cost. If for whatever reason the person or persons who make spending decisions take less than full account of the cost of spending, then the state will spend on wasteful projects by forcing others to pay a share of the price. Debt is just such a way to externalize costs. (By contrast, a state borrows too little if it cannot fund positive-value projects, the costs of which are borne by current taxpayers but the benefits of which extend to future or foreign residents.)

This Part explores the leading explanations of excessive state debt. Scholars have identified two principal, competing theories: the incentive of a state, understood as a collective entity, to externalize financial risk onto residents of other states; and the difficulty a state’s residents experience in monitoring political actors who may find it in their personal interest to fund current spending projects with future payment obligations. Parts III and IV will consider the impact tax-credit borrowing might have on these problems.

#### *A. Risk Externalization*

As it applies to the states, risk externalization refers to the tendency of a state to push some of the expected cost of debt repayment onto the residents of other states, typically by seeking federal aid. On this view, states systematically overborrow as they try to impose the losses associated with bad fiscal conditions on sister states through the use of federal-government resources. Lenders, whether they be bond buyers, trade creditors, or employees, charge the state for its leverage,<sup>122</sup> but they charge less than they would absent the possibility of federal assistance. The joint surplus of the

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122. And the empirical evidence shows that lenders do adjust prices as a state becomes more or less likely to default. See Rodden, *supra* note 20, at 128.

state and its creditors is maximized by shifting some of the cost of debt. Thus, the state borrows more than it would if a federal backstop were unavailable.

An analogy to corporate law may help clarify the intuition. It is hornbook law that corporations enjoy limited liability. The significance of this doctrine is straightforward: creditors are out of luck if the value of corporate assets cannot fully compensate them; they may not demand that shareholders make them whole. As a consequence, shareholders, and presumably the managers who represent them, do not fully weigh the probable costs of the firm's activities. Their private loss is capped at the amount of investment, but the potential public injury is not. Scholars have long attacked limited liability on the ground that it encourages inefficiently risky projects, the downside costs of which are borne by involuntary creditors (for example, tort victims<sup>123</sup>). And it is this very concern that underlies bonding requirements in some industries as well as the familiar rules of corporate-veil piercing. The aim of such policies is to force corporate decisionmakers to internalize the expected costs, as well as the benefits, of the risks they undertake.

Unlike private firms, states cannot externalize financial risk by operation of law. They rely on positive action from the federal government, whether in the form of congressional appropriation or discretionary spending by the executive. But why would the federal government assist a financially distressed state, especially since doing so would tend to exacerbate moral hazard? There are two general rationales: economic self-interest and sympathetic identification.

The self-interest story begins with the intimate economic relationship of states in a fiscal federation such as the United States.<sup>124</sup>

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123. E.g., David W. Leebron, *Limited Liability, Tort Victims, and Creditors*, 91 COLUM. L. REV. 1565, 1565 n.4 (1991) (collecting sources); Larry E. Ribstein, *Limited Liability and Theories of the Corporation*, 50 MD. L. REV. 80, 128–29 (1991) (“Maybe limited liability should be denied to firms that adopt limited liability only with respect to tort creditors or that have less than a minimal amount of capitalization or insurance.”); see generally Henry Hansmann & Reinier Kraakman, *Toward Unlimited Shareholder Liability for Corporate Torts*, 100 YALE L.J. 1879 (1991) (comparing the consequences of limited and unlimited liability for corporations).

124. To be clear, it is the degree of correlation of states' economies that matters for this purpose, not their formal status as members of a fiscal federation. See generally Stephen J. Choi, Mitu Gulati & Eric Posner, *The Evolution of Contractual Terms in Sovereign Bonds*, 4 J. LEGAL ANALYSIS 131 (2012) (generalizing reasons why, in the sovereign context, third-party countries may bail out debtors). Yet because the economies of federal members tend to be more linked than, say, the economies of New Zealand and Hungary, the threat of externalization looms largest in the context of a fiscal federation.

When states' economic lives are closely intertwined, one state's default—and even uncertainty regarding the possibility of its default—can ripple through the broader economy. The economic depression associated with massive debt obligations reduces wealth in the affected state, and therefore reduces demand by the state's residents for the goods and services produced in other states. Imagine, for example, that California's forty million citizens suddenly stopped buying products from the rest of the country. It would devastate industry far beyond state lines, and the multiplier effect could wreak havoc. This is an unrealistically extreme example, of course, but it grimly illustrates the spillover effects of financial distress. Contagion more narrowly defined is also a threat. If a state's default were to fall particularly hard on a certain class of creditor—say, financial institutions—then the effect could ripple quickly through the economy. Thus, when one state's default seems possible, it may be in the nation's interest to intervene with assistance. Indeed, federal governments struggle greatly not to provide assistance when doing so would avoid a greater calamity.<sup>125</sup>

There is reason to doubt how serious of an issue contagion really is in the state–federal context. If, for example, a state's debt were held by its own citizens in proportion to income, then a default would accomplish precisely the same thing as a tax increase. The likelihood of contagion is an empirical question, the resolution of which is beyond this Article's scope. But in any event, the important question for assessing federal incentives is not how contagious states' default *ought* to be as a matter of economic theory. It is how markets will react on this score—and the risk of a bad reaction may itself supply a reason to intervene.

A less rigorous, yet perhaps equally important, explanation for risk externalization is simple fellow feeling. One does not like to see one's countrymen suffering, especially if those suffering do not appear immediately at fault. At a general level this explanation has nothing to do with debt per se. Think of the popularity of federal disaster-relief programs. Whether explicitly or implicitly, the federal government partially insures victims of natural disaster.<sup>126</sup>

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125. See Levitin, *supra* note 10, at 499 (observing that “when scared, governments bail, as shown by the United States in 1992 (bailing out Mexico absent authority), the United States in 2008 (stretching section 13(3) authority), and the European Union in 2010 (bailing out Greece despite a no-bailouts clause in the E.U. Treaty)”).

126. Howard Kunreuther, *Disaster Mitigation and Insurance: Learning from Katrina*, 604 ANNALS AM. ACAD. POL. & SOC. SCI. 208, 214–16 (2006).



Catastrophic damage is often seen as an act of God, even though it is widely known that the probability of natural disaster is much greater in some regions of the country than in others.<sup>127</sup> This insurance gives rise to moral hazard, leading to greater-than-optimal investment in disaster-prone areas, and represents a form of risk externalization. A similar dynamic is at play in calls to help “blameless” communities facing crushing debt.<sup>128</sup>

Self-interest and pity are cumulative, and it is some admixture of the two that explains the federal urge to bail out heavily indebted states. The empirical significance of risk externalization is unfortunately difficult to test. For one thing, it is no small matter even to agree on when a “bailout” has happened. The responsible political actors are unlikely to label their actions as such. Relief may not be directed immediately to creditors. Instead, it will more likely be packaged as assistance to a community—to local industry or to individual residents. In 2013, Detroit’s emergency manager declared that he would not seek federal dollars to pay off creditors, but that the city would need special assistance to tear down dilapidated buildings.<sup>129</sup> Because money is fungible, this is an economically irrelevant distinction. The question is simply whether a jurisdiction and its creditors, viewed as a joint enterprise, are able to extract more cash from the federal treasury than they would otherwise be entitled to. Yet rhetorical ambiguities make the problem a difficult one to study.

It is also important to keep in mind that even with the possibility of a federal bailout, traditional creditors will respond to a state’s financial distress by lobbying for concessions (that is, revenue increases or spending cuts). Federal assistance is unlikely to make creditors whole; creditors would prefer that the state pay in full. The

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127. *Where to Live to Avoid a Natural Disaster*, N.Y. TIMES, Apr. 30, 2011, <http://www.nytimes.com/interactive/2011/05/01/weekinreview/01safe.html> (reporting that residents of Corvallis, Oregon, face the smallest risk, and that Dallas, Texas, is most prone to natural disaster).

128. Consider in this regard the recent reports from Detroit that 911 calls are typically unanswered for an hour, notwithstanding that the city is sitting on billions of dollars of art. See Lisa Lambert, *‘No Bailout’: Senators Look To Pre-empt U.S. Aid to Detroit*, REUTERS, July 25, 2013, available at <http://www.reuters.com/article/2013/07/25/us-usa-detroit-congress-idUSBRE96O1DO20130725>; Kim Peterson, *A 911 Response in Detroit Takes How Long?*, MSN (July 9, 2013, 1:52 PM), <http://money.msn.com/now/post--a-911-response-in-detroit-takes-how-long>.

129. Jonathan Oosting, *Michigan Approved for \$100 Million in Federal Funding to Demolish Blighted Homes in 5 Cities*, MLIVE, June 6, 2013 (4:27 PM, updated June 6, 2013, 7:17 PM), [www.mlive.com/politics/index.ssf/2013/06/michigan\\_100\\_million\\_demolition.html](http://www.mlive.com/politics/index.ssf/2013/06/michigan_100_million_demolition.html).

extent of a state's apparent moral hazard will thus turn in part on the political power of creditors. Consider, for example, the largely foreign creditors who bore the brunt of state defaults in the 1840s.<sup>130</sup> They were unable to exert the influence needed to right the ship before it was too late. A very different picture emerges if some or all creditors are effective political operators. Could public-employee unions be such a class? The jury is out.

Whatever the exact empirical significance of risk externalization, many thoughtful observers believe it to be a significant factor in state-debt levels. As Professor Clayton Gillette observes, "Credit markets likely apply a positive value to the probability of a federal bailout of states, just as they applied a positive value to the probability of a federal bailout of Fannie Mae and Freddie Mac, notwithstanding the absence of any legal obligation."<sup>131</sup> And recent calls for explicit federal bond insurance, an indirect cross-subsidy of the most imprudent states by the most prudent ones, suggest that Gillette is right.<sup>132</sup>

The federal backstop puts a floor on the damage a member state can expect to bear in bad fiscal conditions. As a consequence, a given state's activities reflect a greater appetite for risk than they otherwise would. The state's potential creditors see the same dynamic, and in response charge the state lower interest rates than its default risk would otherwise justify. Neither the state nor its creditors *want* economic turmoil, of course; all do better if the economy remains vital. Yet as a group they maximize their joint surplus by increasing state debt and, therefore, the risk of a calamitous default in the first instance.

To be sure, federal intervention is no certainty. And it is unlikely to make state creditors whole or to come without strings attached. The state-debt markets clearly reflect the heterogeneity of risk posed by investment in the various states.<sup>133</sup> The point is not that states and

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130. William B. English, *Understanding the Costs of Sovereign Default: American State Debts in the 1840's*, 86 AM. ECON. REV. 259, 261 (1996).

131. Clayton P. Gillette, *Political Will and Fiscal Federalism in Municipal Bankruptcy* 52 (N.Y. Univ. Sch. of Law Pub. Law Research Paper Series, Paper No. 11-22, 2011), available at <http://ssrn.com/abstract=1793173>.

132. See, e.g., Richard J. Riordan & Tim Rutten, Op-Ed., *A Plan to Avert the Pension Crisis*, N.Y. TIMES, Aug. 5, 2013, at A17 (arguing that the federal government should intervene and bail out Detroit).

133. See Rodden, *supra* note 20, at 137 (commenting on credit-default-swap prices after 2008).

their creditors fully externalize risk, only that they may do so on the margins and to a degree that significantly affects state policy.

### B. Agency Problems

A competing, though complementary, suite of theories explains overborrowing as a consequence of political dysfunction within a state. Although the details of these theories vary, they share a fundamental premise: that elected representatives find it in their self-interest to borrow excessively to fund current expenditures. These theories depend on a corollary view that the polity does a poor job of disciplining political actors who take on debt to pay for projects that the polity, as a whole, values below cost.

A vast literature, dating at least to Adam Smith, explains why incumbent politicians are often willing to eat the seed corn, spending today on popular projects while seeking to pay for them tomorrow.<sup>134</sup> More recent theorists have set out a number of rationales to explain why elected representatives might choose to fund current spending with debt rather than with tax revenue. Imagine, for example, an incumbent who anticipates that his spending priorities will differ from those of his successors.<sup>135</sup> Such an incumbent may want to borrow in the current term in order to constrain the spending possibilities of future officeholders.<sup>136</sup> One model suggests that representatives who desire a low-spending policy will over-rely on borrowing for the same reason.<sup>137</sup> Or a representative may believe that his tenure in office depends on constituents who value current spending highly because they do not expect to pay their fair share of future taxes—either

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134. See, e.g., 2 ADAM SMITH, *AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS* bk. V, ch. III (Edwin Cannan, ed., Methuen & Co., 5th ed. 1904); DAVID RICARDO, *Essay on the Funding System*, in *THE WORKS OF DAVID RICARDO* 455 (McCulloch ed., 1846); Richard E. Wagner, *Revenue Structure, Fiscal Illusion, and Budgetary Choice*, 25 *PUB. CHOICE* 45 (1976); see generally Alberto Alesina & Allan Drazen, *Why Are Stabilizations Delayed?* (Nat'l Bureau of Econ. Research, Working Paper No. 3053, 1989), available at [http://dash.harvard.edu/bitstream/handle/1/4553028/alesina\\_why\\_stabilizations.pdf?sequence=2](http://dash.harvard.edu/bitstream/handle/1/4553028/alesina_why_stabilizations.pdf?sequence=2).

135. See, e.g., Torsten Persson & Lars E. O. Svensson, *Why a Stubborn Conservative Would Run a Deficit: Policy With Time-Inconsistent Preferences*, 104 *Q. J. ECON.* 325, 325 (1989).

136. Alberto Alesina & Guido Tabellini, *A Positive Theory of Fiscal Deficits and Government Debt*, 57 *REV. ECON. STUD.* 403, 403 (1990) (offering the example of two parties who disagree about spending priorities, with each encouraged to use debt strategically).

137. See generally Roland Hodler, *Elections and the Strategic Use of Budget Deficits*, 148 *PUB. CHOICE* 149 (2011) (explaining how an incumbent who prefers low public spending will use debt to constrain later high-spending officials).

because they expect to move or because they expect to pay a low tax rate in the future.

Politicians' preferences are of course constrained. At times, the popular will has reflected a powerfully antidebt sentiment. After the defaults of the 1840s, the people in many states ratified constitutional amendments aimed at eliminating or at least reducing the tendency to rely on borrowing.<sup>138</sup> Those were different times, of course, and most scholars believe the amendments did little to curb debt in the long term.<sup>139</sup> But those amendments do indicate a limit to society's tolerance of debt. Agency theories of excessive debt do not reject that principle; they posit only that states tend to overborrow.

But why would voters tend not to punish politicians for spending on unworthy projects, even if the spending is put off to the future? A partial explanation looks to the differences among constituents in the proportion of benefits received from spending initiatives and costs borne under current and anticipated tax policy. Perhaps constituents who benefit from excessive debt are better able to form powerful coalitions. Dispersion on the part of those harmed may prevent them from learning about borrowing policy, from doing anything about it, or both. On another prevalent account, many residents are simply fiscally deceived.<sup>140</sup> Current taxes and levels of services are salient, but people do not perceive as clearly the consequences of future obligations to repay: out of sight, out of mind. A former Chicago alderman speaking recently about the city's looming pension crisis nicely summed up this agency theory of excessive debt: "Voters don't care about pensions as an abstract issue. . . . What they care about are the effects over the next two years of having to cut services or raise taxes to pay for this."<sup>141</sup> What these explanations have in common is the assumption of a voting public that is ill-suited to monitor and discipline spendthrift politicians.

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138. See Roin, *supra* note 64, at 1975 ("Constitutional limitations on the use of state government debt did not appear until the 1840s."); Silvers, *supra* note 3, at 42 ("When states were unable to repay their borrowings, they went through painful periods of fiscal adjustment that led to the adoption in most states of rules forbidding states to run operating deficits and limiting borrowing to funding discrete capital investments.").

139. Isabel Rodriguez-Tejedo & John Joseph Wallis, *Fiscal Institutions and Fiscal Crises*, in *WHEN STATES GO BROKE*, *supra* note 3, at 9, 37; Roin, *supra* note 64, at 1977–78.

140. See generally Wagner, *supra* note 134 (describing how taxpayer perceptions of the cost of government can be influenced by the complexity of methods used to finance public output).

141. Monica Davey & Mary Williams Walsh, *Chicago Sees Pension Crisis Drawing Near*, N.Y. TIMES, Aug. 6, 2013, at A1, available at <http://www.nytimes.com/2013/08/06/us/chicago-sees-pension-crisis-drawing-near.html> (quotation marks omitted).

One might expect market forces to constrain politicians' appetite for borrowing even if voters do not. In the corporate-debt market, for example, lenders carefully monitor their borrowers' leverage. The higher the leverage, the greater the risk of default if revenues decrease relative to market expectations.<sup>142</sup> To compensate for the risk of default, lenders therefore charge higher interest rates to more highly leveraged firms, all else being equal. At some point credit simply dries up. This may be true in the state-debt markets, too, and it would suggest a ceiling to state indebtedness. But because lenders care about risk-adjusted returns rather than the wisdom of their borrowers' expenditures, the point at which creditors simply stop lending is not likely related to optimal fiscal policy.

### III. TAX-CREDIT BORROWING AND RISK EXTERNALIZATION

Risk externalization depends on the possibility of federal succor, and its importance grows with the likelihood that financial distress will meet a receptive audience in Washington. Those concerned with the associated moral hazard have observed that federal aid is more likely when a state can claim an inability to service its massive debt burden. The pathetic appeal to helplessness, coupled with the threat of spillover effects and contagion that might follow a disorderly default, therefore combine to powerful effect. Seeking to relieve bailout pressure, and therefore moral hazard, a number of scholars in the last few years have proposed legislation permitting states to seek bankruptcy relief.<sup>143</sup> The details have varied, but they generally have taken as a model Chapter 9 of the Bankruptcy Code.

This Part gives background on Chapter 9 and the state-bankruptcy debate, and argues that voluntary debt-adjustment mechanisms are unlikely to dampen moral hazard. It then shows how tax-credit borrowing could more effectively achieve the aims motivating proposals for state-bankruptcy legislation.

#### A. *Background: Chapter 9 and the State-Bankruptcy Debate*

Prior to the Great Depression, no formal mechanism existed by which the debt of public entities could be restructured. In 1933,

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142. Leverage refers to the ratio between the debts a firm owes and its assets. A low degree of leverage implies a large equity cushion to absorb losses before they affect creditors.

143. See *supra* note 10 and accompanying text; see also Triantis, *supra* note 44, at 240; Adam Feibelman, *Involuntary Bankruptcy for American States*, 7 DUKE J. CONST. L. & PUB. POL'Y 81, 81–83 (2012).

Congress amended the Bankruptcy Act to allow distressed towns and cities to adjust debts that had become unsustainable as the national economic malaise persisted.<sup>144</sup> This legislation was addressed in particular to the familiar problem of holdout creditors. When a debtor entity's liabilities become too great relative to its ability to generate revenue, a measure of relief can be in the best interests of the debtor and its creditors alike. The Great Depression undoubtedly saw many such cases.<sup>145</sup> Individual creditors may nevertheless withhold consent to a sensible plan of adjustment in an effort to capture a greater share than that to which they would otherwise be entitled. The principal sponsor of the first municipal-bankruptcy legislation had just this dynamic in mind: "In every instance where a governmental unit finds itself in financial difficulty and is able to make some satisfactory agreement of adjustment with the majority of its creditors, there is always a small minority who hold out and demand preferential treatment."<sup>146</sup> The 1933 amendments sought to overcome holdout by permitting a federal judge to approve a settlement acquiesced to by a supermajority of creditors.<sup>147</sup>

The Supreme Court promptly held the amendments unconstitutional, on the puzzling theory that the federal government's grant of an option to discharge debts intruded on state sovereignty.<sup>148</sup> (Bankruptcy was purely optional because involuntary petitions of the type familiar to individual and corporate bankruptcy were forbidden.<sup>149</sup>) Congress enacted substantially identical legislation in 1937, and after the famous "switch in time" the Court upheld the new

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144. Unlike state legislatures, Congress may impair the obligation of contracts under its authority "[t]o establish . . . uniform Laws on the subject of Bankruptcies throughout the United States." U.S. CONST. art. I, § 8, cl. 4; see *Hanover Nat'l Bank v. Moyses*, 186 U.S. 181, 188 (1902) (holding that the Bankruptcy Clause empowers Congress "to discharge the debtor from his contracts and legal liabilities").

145. See generally, e.g., *Faitoute Iron & Steel Co. v. City of Asbury Park*, 316 U.S. 502 (1942); Randall S. Kroszner, *Is It Better to Forgive Than to Receive? An Empirical Analysis of the Impact of Debt Repudiation* (Ctr. for Research in Sec. Prices, Working Paper No. 481, 2003).

146. *To Amend the Bankruptcy Act: Municipal and Private Corporations: Hearings on H.R. 1670, H.R. 3083, H.R. 4311, H.R. 5009, and H.R. 5267 Before the H. Comm. on the Judiciary*, 73rd Cong. 22 (1933) (statement of Rep. J. Mark Wilcox).

147. *Ashton v. Cameron Cnty. Water Improvement Dist. No. One*, 298 U.S. 513, 526 (1936) ("After hearing, the judge shall confirm the plan, if satisfied that it is fair, equitable, for the best interests of the creditors, does not unduly discriminate, complies with the statute, and has been accepted by those holding two-thirds of the indebtedness.").

148. *Id.* at 531.

149. *Id.* at 524-25.

bill.<sup>150</sup> Federal law has provided some kind of municipal-bankruptcy process ever since. The regime in effect today was in large measure established with the advent of the Bankruptcy Code in 1978. Others have admirably canvassed the significance of Chapter 9's various provisions;<sup>151</sup> I need not replicate their work here. A few of the details are, however, important to the questions this Article raises, and it will be useful to touch on them briefly.

One important set of rules concerns eligibility. Chapter 9 is available to "municipalities" only,<sup>152</sup> on a strictly voluntary basis.<sup>153</sup> A municipality seeking relief must be empowered to do so by state law, must be insolvent, and before filing a petition must try to reach an accommodation with creditors unless "such negotiation is impracticable."<sup>154</sup> The insolvency requirement is particularly important. With respect to Chapter 9, the Bankruptcy Code adopts a cash-flow understanding of insolvency, providing that a municipality is insolvent only if it is "generally not paying its debts as they become due" or is "unable to pay its debts as they become due."<sup>155</sup> Some federal courts have understood this to mean that Chapter 9 is available only if a municipality will be unable to pay its bills within the fiscal year (taking borrowing capacity and taxing powers into account).<sup>156</sup> In this way the Bankruptcy Code circumscribes quite narrowly the domain of municipal bankruptcy, perhaps too narrowly.<sup>157</sup>

It is important to understand something of the law's reach as well as its subject. Here again, Chapter 9's ambition may seem modest. In a corporate reorganization under Chapter 11, the bankruptcy judge may if necessary cram down a plan of reorganization with widespread

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150. *United States v. Bekins*, 304 U.S. 27, 51–54 (1938).

151. The best scholarly introduction to, and evaluation of, Chapter 9 is still McConnell & Picker, *supra* note 12.

152. 11 U.S.C. § 109(c)(1) (2012).

153. *Id.* § 303(a) (2012) ("An involuntary case may be commenced only under chapter 7 or 11 of this title.").

154. *Id.* § 109(c)(2)–(3), (5) (2012).

155. *Id.* § 101(32)(C) (2012).

156. *In re City of Bridgeport*, 129 B.R. 332, 336–37 (Bankr. D. Conn. 1991); *In re Villages at Castle Rock Metro. Dist. No. 4*, 145 B.R. 76, 84 (Bankr. D. Colo. 1990).

157. See McConnell & Picker, *supra* note 12, at 456–57 ("While the gatekeeper function reduces the moral hazard of easy debt relief, the insolvency standard almost certainly makes both creditors and debtor worse off in those cases actually culminating in bankruptcy.").

consequences for the debtor enterprise.<sup>158</sup> Chapter 11 plans routinely contemplate the sale of a significant percentage of assets, the spinoff of entire business units, or even the total reconstitution of governance through auction.<sup>159</sup> In Chapter 9 proceedings, by contrast, the bankruptcy judge may do little more than approve a plan reducing the municipality's debts in a manner consistent with the "fair and equitable" standard.<sup>160</sup> The court has no power to decree that a debtor entity's assets or taxing power be put to a particular use; it cannot compensate frustrated creditors with the keys to City Hall.<sup>161</sup> Chapter 9 is thus oriented toward a singular function—the elimination of debt overhang.

The first proposals for a state-bankruptcy law were premised on this model. Consistent with the origins of municipal bankruptcy, proponents noted the potential of legislation to cure debt overhang.<sup>162</sup> But their *bête noir* was a different animal: the moral hazard of risk externalization.<sup>163</sup> Advocates of a state-bankruptcy procedure take the view that the existence of an orderly process for adjusting state debts, a process with the patina of law, could weaken the political argument in favor of federal assistance. As one commentator put it, "The appeal of bankruptcy-for-states is that it would give the federal government a compelling reason to resist the bailout urge."<sup>164</sup> This, in turn, could ameliorate states' moral hazard by forcing them and their creditors jointly to internalize the risks of bad fiscal conditions. The proposed law would mirror Chapter 9 in important respects. To avoid

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158. 11 U.S.C. § 1129 (2012) (setting out conditions on satisfaction of which a plan "shall" be confirmed). A cramdown refers to a plan confirmed over the objection of at least one class of creditors.

159. See, e.g., Douglas G. Baird & Robert K. Rasmussen, Reply, *Chapter 11 at Twilight*, 56 STAN. L. REV. 673, 675–85 (2003).

160. 11 U.S.C. § 901(a) (2012) (incorporating relevant portions of 11 U.S.C. § 1129 (2012)).

161. *Id.* § 904 (2012) ("Notwithstanding any power of the court, unless the debtor consents or the plan so provides, the court may not, by any stay, order, or decree, in the case or otherwise, interfere with—(1) any of the political or governmental powers of the debtor; (2) any of the property or revenues of the debtor; or (3) the debtor's use or enjoyment of any income-producing property."). Notwithstanding this literal reservation of power, commentators have noted that a bankruptcy judge could push for changes to governance structure by refusing to confirm any plan that did not "consent" to favored changes. E.g., Gillette, *Fiscal Federalism*, *supra* note 10, at 293–95 ("[T]he apparently clear rule that the court may not require resource adjustments becomes more opaque once one considers the discretion that a court does have to condition the grant of relief in Chapter 9 on the political will of residents to accept them.").

162. Skeel, *States of Bankruptcy*, *supra* note 10, at 687–88.

163. Feibelman, *supra* note 143, at 93; Skeel, *States of Bankruptcy*, *supra* note 10, at 691; Triantis, *supra* note 44, at 238.

164. Skeel, *Give States*, *supra* note 9, at 3.



constitutional doubt, resort to the procedure would need to be voluntary. The bankruptcy judge would be empowered to impose a plan of adjustment on holdout creditors, but would have few other powers (again out of concern for state sovereignty). The process would also allow states to reject and renegotiate onerous executory contracts, in particular labor deals that were the product of collective bargaining.<sup>165</sup>

Academic reception of proposed state-bankruptcy procedures has been as mixed as the political response. Skeptical commentators have lodged two general objections: first, that the particular moral hazard is simply not a significant determinant of state financing policy;<sup>166</sup> and second, that for structural and constitutional reasons bankruptcy is ill-suited to the task of reforming state behavior.<sup>167</sup> At least one pair of commentators has charged that state bankruptcy would in practice be used as a Republican tool to punish labor unfairly.<sup>168</sup> Others have considered the general idea of a restructuring mechanism sound, but have quibbled over the design. Could states strategically invoke the prospect of bankruptcy to achieve even better bailout terms?<sup>169</sup> Perhaps it would be better to enact a “minimalist” adjustment mechanism limited to ratifying haircuts agreed to by a supermajority of creditors,<sup>170</sup> or to supply states with a menu of choices.<sup>171</sup> My purpose here is not to critique each conceivable

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165. See 11 U.S.C. § 365 (2012) (“Except as provided . . . the trustee, subject to the court’s approval, may assume or reject any executory contract . . .”). Chapter 11’s restrictions on the modification of collective-bargaining contracts do not apply in Chapter 9. 11 U.S.C. § 901(a); *In re City of Vallejo*, 403 B.R. 72, 76 (Bankr. E.D. Cal. 2009).

166. See Levitin, *supra* note 3, at 221 (“There is a vast literature on the political economy of budget deficits. Although it identifies many political economy factors that may contribute to deficits, it has identified political agency problems as a particular cause, as politicians seeking private benefits and subject to limited electoral discipline run up state spending without corresponding revenue increases.”); Silvers, *supra* note 3, at 56 (“[F]ederal-state transfers necessary to keep states economically healthy are relatively small amounts compared to the aid given to the financial system or the tax breaks offered or renewed at a federal level since 2007. It is not an issue of money; it is an issue of political honesty and political will—the honesty to admit that states are not really fiscally independent of the federal government and the will to act responsibly in accordance with that reality.”).

167. Gelpert, *supra* note 10, at 1113; Levitin, *supra* note 3, at 214–15; Schragger, *supra* note 25, at 881–82.

168. Catherine Fisk & Brian Olney, *Labor and the States’ Fiscal Problems*, in *WHEN STATES GO BROKE*, *supra* note 3, at 253, 293. For a more thorough explication of the prevailing critiques of state-bankruptcy proposals, see generally Skeel, *Is Bankruptcy*, *supra* note 10.

169. Gillette, *Fiscal Federalism*, *supra* note 10, at 328.

170. Schwarcz, *supra* note 10, at 331.

171. Triantis, *supra* note 44, at 242 n.11.

permutation of federal legislation. This excursion is rather meant to establish two points about the state-bankruptcy debate. First, whether they support or oppose a formal debt-adjustment process, scholars almost unanimously assume that some kind of congressional action would be needed to achieve it.<sup>172</sup> Second, the starting place for the debate has been Chapter 9.

*B. State Eligibility for Chapter 9 Absent Legislation*

Undoubtedly, states are formally ineligible for bankruptcy relief. The Bankruptcy Code permits only a “municipality” to be a debtor under Chapter 9,<sup>173</sup> and that term is defined as a “political subdivision or public agency or instrumentality of a State.”<sup>174</sup> The states themselves are excluded by implication. Congressional amendment would be necessary to bring a state qua state within the Bankruptcy Code’s ambit.

In functional terms, though, the states are free to structure their debts so as to fit the Bankruptcy Code’s capacious definition of a “municipality.” Suppose that Illinois wished to become Chapter 9–eligible. It could charter an instrumentality—call it Schmillinois—for the sole purpose of issuing the state’s debt. Schmillinois would issue general-obligation bonds; it would promise to back state employees’ pension rights; it would cut checks to the state’s trade creditors. In short, Schmillinois would act as the state’s financing arm, funded presumably through annual appropriations. Yet it would not *be* the state. It would have none of the sovereignty vested in the state by the Constitution, and it would exist firmly under the state’s dominion. In form, Schmillinois would resemble the many other instrumentalities and agencies with authority to act within the state, without regard to the geographical boundaries associated with towns and cities.

There is no reason to think a special-purpose instrumentality of this kind would not qualify as a “municipality.” Courts interpreting the term’s meaning for eligibility purposes have looked to a variety of factors. They have considered, for example, the extent to which a would-be petitioner engages in traditional governmental functions; the extent to which the putative municipality is subject to state rather than private control; and, perhaps most importantly, whether the

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172. *Id.* at 240–41; McConnell & Picker, *supra* note 12, at 229; Levitin, *supra* note 3, at 214–16. *But see* Hynes, *supra* note 10, at 698 (arguing that composition under state law is sufficient).

173. 11 U.S.C. § 109(c)(1) (2012).

174. *Id.* § 101(40).

state itself categorizes the entity as a municipality or instrumentality.<sup>175</sup> Schmillinois would seem to withstand scrutiny quite easily.<sup>176</sup>

Chapter 9's availability to states as a debt-adjustment mechanism suggests that the question scholars have been debating—namely, whether Congress should enact state-bankruptcy-enabling legislation—should be restated. The question is rather why states have not availed themselves of the power they already have to make their debt adjustment-eligible. This section explores possible explanations that suggest a skeptical point of view not only about “Chapter 9 for states,” but indeed about the utility of virtually any restructuring mechanism that turns on state consent.

The most obvious explanation of the states' continued Chapter 9 ineligibility is that state leaders have not thought eligibility possible. To be sure, this Article marks, as far as I am aware, the first suggestion that states can effectively opt into Chapter 9 eligibility. The existing literature is to the contrary, and explicitly so.<sup>177</sup> In general, it is precisely states' assumed ineligibility that has motivated proposals for federal legislation in the first place. But failure of imagination is not an altogether satisfying explanation. State policymakers have long used instrumentalities and special-purpose districts to carry out state capital projects and operations. Instrumentalities are often used to impose state-level policies in the face of local opposition; at other times they are used to incur debt for state-desired projects otherwise frustrated by balanced-budget amendments and other restrictions on indebtedness.<sup>178</sup> And these instrumentalities are not always geographically defined—consider, for

175. See *In re Las Vegas Monorail Co.*, 429 B.R. 770, 795 (Bankr. D. Nev. 2010).

176. Eligibility litigation to date has turned on whether an entity should be classified as a municipality (in which case Chapter 9 is appropriate), or as a business firm (which must petition under Chapters 7 or 11, but not 9). Courts have not been asked to decide whether a would-be petitioner *is a state*. But for the reasons I give, it is hard to see how an entity with powers limited by charter could be confused with a sovereign state.

177. Levitin, *supra* note 3, at 214–16; McConnell & Picker, *supra* note 12, at 229; Schwarcz, *supra* note 10 at 326; Triantis, *supra* note 44, at 240–41. Richard Hynes has documented how states may, and perhaps already do, take advantage of Chapter 9 by moving obligations from the state ledger to the balance sheets of various state-administered instrumentalities. See Hynes, *supra* note 10, at 683–90. In some respects the structure I suggest is quite similar to this “synthetic” bankruptcy: both models turn on the juridical difference between a sovereign and its instrumentalities. Yet the model here suggested would effectively allow for the adjustment of the entirety of a state's capital structure.

178. See Roin, *supra* note 64, at 1978–80 (explaining this phenomenon and offering an example from the Seattle Mariners' baseball stadium).

example, state university systems. In the history of municipal bankruptcy, the vast majority of petitions have been filed on behalf of these quasi-state entities rather than traditional towns and cities.<sup>179</sup> Given the prevalence of instrumentalities in state operations and particularly in the world of municipal bankruptcy, it is rather hard to believe that no one has considered going whole hog.

Another possibility is that state policymakers simply regard Chapter 9 as ineffectual and hence not worth the (modest) transaction costs that becoming eligible would entail. This explanation has some bite at first glance. Scholars and practitioners alike have shrugged at the limited benefits of municipal bankruptcy since its most recent incarnation in 1979. Chapter 9's requirement that a municipality be insolvent before seeking protection is a particularly counterproductive hurdle. It is unclear what it means for a municipality to be "unable" to pay debts becoming due within the fiscal year. A weak version of "inability" would describe something like the political infeasibility of raising sufficient revenue to pay creditors in light of, for example, necessary operational expenses and the reality of voter preferences. On this view bankruptcy judges might defer in some measure to the representations of elected officials, who presumably are best situated to describe the conditions of the electorate. But a stronger version would look to the theoretical power of a jurisdiction to meet the year's obligations, whether by further tapping the credit markets or through a combination of tax increases and spending reductions. At some point, marginal tax increases and spending cuts will reduce a jurisdiction's total revenue. But the precise definition of a jurisdiction's Laffer curve<sup>180</sup> is anyone's guess; and to the extent a municipality bears the burden of persuasion on this score, the insolvency requirement can dramatically reduce Chapter 9's usefulness.<sup>181</sup> Financial distress is often a problem long before a municipal debtor *cannot* pay in the strong sense. By that point, it may be a story of too little, too late.

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179. Omer Kimhi, *Chapter 9 of the Bankruptcy Code: A Solution in Search of a Problem*, 27 YALE J. ON REG. 351, 359 n.43, 360–61 (2010) (describing Chapter 9 as "used by tiny municipalities under peculiar circumstances").

180. The Laffer curve illustrates the idea that tax rates affect productivity. See Jude Wanniski, *Taxes, Revenues, and the "Laffer Curve,"* 50 PUB. INT. 3, 3–7 (Winter 1978). At a tax rate of 0 percent, the government collects no revenue. At a rate of 100 percent, it similarly collects very little, because those subject to taxation lack incentive to produce (and indeed they may spend resources trying to evade taxation). The maximum revenue a government can collect in tax will lie at some unknown intermediate rate.

181. McConnell & Picker, *supra* note 12, at 456.

The relatively narrow powers of the bankruptcy judge in Chapter 9 may also limit its usefulness. As mentioned above, the bankruptcy court has no power to restructure a debtor municipality along the lines of Chapter 11.<sup>182</sup> The bankruptcy judge cannot order changes to the municipality's geographical boundaries or to its governance structures.<sup>183</sup> Nor can she decree tax increases or spending reductions.<sup>184</sup> Some have argued that a forum in which adjustments to taxing and spending rates are on the table would be preferable to the present regime.<sup>185</sup>

Yet ultimately the limited scope of Chapter 9 cannot explain states' perceived ineligibility. Whether amendments could make Chapter 9 more valuable is an important issue, but at this point a secondary one. A state could become bankruptcy-eligible for the cost of repairing a few dozen potholes. And Chapter 9 does seem to provide *some* net value in the municipal context. Many states think so, anyway.<sup>186</sup> Otherwise they would withhold permission for their municipalities to seek relief.

A better explanation lies in the very moral hazard that has motivated calls for state-bankruptcy legislation. Disinterested observers may rue the threat of contagion on either efficiency or distributive grounds. They may see it as a distorting influence on state financial policy or as an unjustified affront to proper federal-state relations. From the perspective of a too-big-to-fail state, though, things look quite different. The threat of contagion turns the federal government into a (partial) guarantor of state debt, which reduces the cost of borrowing. Being contagious, then, is valuable. Any mechanism that reduces the possibility of a bailout is bad in the state's eyes for the same reason the general polity approves it. If state

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182. See *supra* text accompanying notes 159–62.

183. 11 U.S.C. § 904 (2012) (prohibiting judicial “interfere[nce]” with, among other things, “any of the political or governmental powers of the debtor”).

184. *Id.*

185. Gillette, *Fiscal Federalism*, *supra* note 10, at 284–86.

186. The states as a whole are mixed on this. See Kenneth E. Noble & Kevin M. Baum, *Municipal Bankruptcies: An Overview and Recent History of Chapter 9 of the Bankruptcy Code*, ASS'N OF CORPORATE COUNSEL (July 23, 2013), available at <http://www.lexology.com/library/detail.aspx?g=c47c30f7-e91f-4398-82f3-f0ce5d2ef704> (“Twelve states specifically authorize chapter 9 filings, while 12 others permit bankruptcy filings given a further action to be taken by a state, official or other entity. In addition, three other states authorize a limited subset of municipalities to file for bankruptcy. The remaining 23 states do not authorize municipal bankruptcy filings.”).

bankruptcy can be expected to reduce states' incentive to seek federal bailouts, why would a state opt in voluntarily?

The primary virtue of Chapter 9, such as it is, lies in its capacity to eliminate debt overhang by reducing a distressed municipality's liabilities over the objection of holdout creditors.<sup>187</sup> If its debt burden becomes too great, a city may be unable to raise revenue even for capital expenditures and operations that a vast majority of residents would be inclined to pay for. The residents, knowing that a large fraction of each marginal dollar paid into the communal chest is destined for creditors' pockets, will tend to lobby for minimal taxes and fees. Adjusting debts may be the best solution for the city's residents and creditors alike, and Chapter 9 provides a mechanism through which to accomplish this objective.

Yet to judge the potential appeal of Chapter 9 *to a state*, one must first reflect on the state's own power to address debt overhang and related problems without a bankruptcy process. Without bankruptcy, as previously discussed, state political actors enjoy an effectively unilateral power to restructure debt ad hoc.<sup>188</sup> Indeed, under settled doctrine a Chapter 9 proceeding would constrain rather than enhance state politicians' discretion. One implication of state sovereign immunity, and the states' corresponding ability to restructure debt through default, is that debt overhang is a red herring. When a firm's or an individual's debt burden is too great, the existence of the debt may preclude otherwise efficient junior and equal-priority investment. For the business firm, this means difficulty raising equity financing or unsecured credit. For an individual, debt overhang may, for example, discourage labor or investment in human capital. In theory, debt overhang could have the same effect on a political entity. But because states can eradicate debt overhang through default, it is hard to see why they need to invoke a bankruptcy process, the aim of which is to relieve this very problem.<sup>189</sup>

The upshot is that state actors might lack interest in Chapter 9 because they realize that they can achieve its greatest promise—

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187. The common-pool problem is of limited significance to a municipality. Under longstanding doctrine, creditors have minimal ability to foreclose on municipal assets and so to destroy going-concern value. For a thorough explanation, see McConnell & Picker, *supra* note 12, at 430–33.

188. This unilateral power represents a significant moral hazard that increases the states' cost of borrowing, all else being equal. For discussion of overcoming the moral hazard, see *supra* text accompanying note 148.

189. Others have made this general point. Gelpert, *supra* note 12, at 894.

reduction of debt overhang—through unilateral action. In Chapter 9, a state would need to appeal to a bankruptcy judge’s discretion in cramming down a plan of adjustment (assuming at least one dissenting class of creditors).<sup>190</sup> Outside bankruptcy, the federal imprimatur is unnecessary.

In talking this way I hope to avoid falling into a composition fallacy. With apologies to Professor Kenneth Shepsle for borrowing his classic phrase, a state is a “they,” not an “it.”<sup>191</sup> Not everyone with political influence in the statehouse benefits from moral hazard. Those who seek stability, or who have less to gain from marginal spending or marginal tax relief, for example, could be expected to lobby for measures reducing moral hazard. If public choice has taught us anything, it is the unpredictable and often unstable nature of political accommodation. Yet it is still useful to think about the incentives of a “state,” just as it is valuable to think about the incentives of a business firm. Horse-trading among constituencies, as among corporate stakeholders, tends to move collective policy along the path of least resistance. In the case of a potentially contagious state, that path is the one which increases rather than decreases the likelihood of federal assistance.

These considerations help explain more than just states’ failure to make themselves eligible for Chapter 9. They also suggest why nearly any ex post federal restructuring measure is doomed to fail if it requires state consent.<sup>192</sup> State political actors will prefer to set their own terms of restructuring, through default, and to threaten disorder,

190. See 11 U.S.C. § 901(a) (2012) (incorporating the requirements to cram down found in Chapter 11 corporate reorganizations, 11 U.S.C. § 1129(b)).

191. Kenneth A. Shepsle, Commentary, *Congress is a “They,” Not an “It”: Legislative Intent as Oxymoron*, 12 INT’L REV. L. & ECON. 239, 239 (1992).

192. Existing proposals for a state-bankruptcy statute uniformly presume that a law under which creditors could force states into court involuntarily would be unconstitutional. See, e.g., Bush & Gingrich, *supra* note 9 (“[N]either the federal government nor state creditors could push an unwilling state into bankruptcy, no matter how catastrophic the state’s finances may be, as this would violate the U.S. Constitution’s protection for a state’s sovereign immunity.”). It is worth noting that, as a matter of existing doctrine, this is far from clear. In *Central Virginia Community College v. Katz*, 546 U.S. 356 (2006), the Supreme Court held that Congress may abrogate state sovereign immunity via its power to make “uniform Laws on the subject of Bankruptcies,” U.S. CONST. art. I, § 8, cl. 4. *Cent. Va. Cmty. Coll. v. Katz*, 546 U.S. 356, 359 (2006). *Katz* concerned the power of a bankruptcy court to order relief against a state as the recipient of a preferential transfer; it did not speak directly of the power to authorize involuntary petitions. 11 U.S.C. § 547 (2012). But the Court’s rationale suggests that Congress could abrogate immunity as it sees fit in the bankruptcy context. See Gelpert, *supra* note 12, at 899 n.29. Still, the meaning of *Katz* is largely academic, since even if involuntary bankruptcy for the states would be constitutional, it is politically infeasible.

rather than capitulate to the jurisdiction of a federal bankruptcy judge.

*C. Tax-Credit Borrowing as a Solution*

Tax-credit borrowing furnishes a more effective deterrent. The optimistic intuition at play is straightforward. The federal government's incentive to bail out is related to the risk of possible spillover effects and contagion associated with a disorderly state default. Sudden, unexpected shortfalls can send shockwaves through the entire associated economy. But tax-credit bonds preclude default. Without default, the logic goes, there is less threat of a federal bailout because there is a less credible threat of contagion. Knowing this *ex ante*, the state and its creditors are forced to internalize the risk of bad fiscal conditions. More precisely, since the debt is risk-free, the state's "residual claimants"—its residents, its voters—are forced to internalize the risk of financial distress. This in turn should lead to lower levels of borrowing.

Of course, contagion is not the only reason the federal government may be inclined to assist distressed states, and it remains possible that federal assistance of other kinds may simply replace the dreaded bailout. A significant part of state money already comes in the form of grants-in-aid not tied to creditor recoveries. Put succinctly, the question is whether the federal government will simply replace one form of assistance with another. In some limited sense the answer must be that it will. Already some federal grants are predicated on the states' relative financial health. Medicaid, for example, ties the share of federal matching funds to the average income of a state's residents.<sup>193</sup> Because a state's financial problems tend to reduce that average income, they simultaneously increase the federal government's generosity. One could see this kind of assistance as an analogue to federal flood insurance, for example. This is the pathetic appeal to help fellow citizens who face hard times without "fault." Yet spillover effects surely matter, in addition to the fellow feeling that defines national identity. And to the degree that externalities in this context are a function, in part, of the disorder and uncertainty of default, a default-proof borrowing mechanism should reduce the federal tendency to intervene even if it cannot hope to eliminate intervention altogether.

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193. Eleanor D. Kinney, *Rule and Policy Making for the Medicaid Program: A Challenge to Federalism*, 51 OHIO ST. L.J. 855, 860 (1990).



The feasibility of tax-credit borrowing depends in the first instance on voluntary state action. It is the state that must choose to finance with tax offsets. This presents a puzzle. If one of the principal effects of a tax-credit borrowing regime is to reduce the states' ability to externalize risk by credibly threatening default, why would a state willingly play along? The same logic that undermines voluntary debt-adjustment proposals would seem to cast the same shadow on tax-credit borrowing.

In some measure, federal legislative action is probably needed to spur tax-credit borrowing. At minimum, as noted earlier, the Tax Code would need to be amended to undo what is in effect a subsidy of traditional bond borrowing.<sup>194</sup> But indeed, parity is likely not enough. A relative subsidy of tax-credit borrowing would likely be necessary to overcome states' natural interest in risk externalization. If it becomes cheaper to borrow with tax credits than with traditional indebtedness, then state decisionmakers must weigh beforehand the value of cheaper debt against the expected value of risk externalization.<sup>195</sup> What the exact size of the relative subsidy must be is, of course, a difficult empirical question. Quite apart from the will of policymakers, the expected liquidity of secondary markets in these new instruments would affect investors' appetite to buy tax-credit bonds offering after-tax yields equal to those of traditional bonds. Some amount of experimentation would be needed; and indeed, one of the virtues of introducing tax-credit borrowing would be its potential to tell us something about the degree of risk externalization that is actually at play in the political economies of the states. It is enough here to suggest that relatively small changes in federal tax policy could do much to encourage tax-credit borrowing.

#### IV. TAX-CREDIT BORROWING AND AGENCY PROBLEMS

Now suppose that risk externalization is not a significant driver of state borrowing patterns. Perhaps states borrow the "right" amount. To the extent they overborrow (relative to their alternative opportunities to increase tax revenue or decrease spending), the reason is a standard agency problem.<sup>196</sup> Those affected by a state's

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194. See *supra* text accompanying note 112.

195. Because the relative subsidy would be a matter of public knowledge, it should have little if any redistributive effect among the states. Depending on the particulars, it could either increase or decrease the total amount of state borrowing.

196. See *supra* Part II.B.

economic activity imperfectly monitor politicians, who find it in their self-interest to finance current expenditures with debt. If this is the best way to think about excessive state debt, what are the implications of a tax-credit borrowing regime? This turns out to be a complex question dependent on a number of assumptions about state political economy. I cannot venture a comprehensive analysis here, but it will be useful to sketch the beginnings of what one might look like.

Tax-credit borrowing could affect state fiscal policy in two respects. First, and most obviously, the power to issue risk-free debt could reduce a state's borrowing costs by eliminating the default premiums creditors inevitably charge.<sup>197</sup> At first blush, this would seem to imply more debt. The cheaper a good, the more one expects to see consumed. But the effect is not altogether clear in this case, because issuing risk-free debt also has implications for the monitoring of political actors. A creditor bearing the risk of default has an incentive to lobby or otherwise push for fiscal policies that will ensure future solvency. A creditor holding risk-free debt has no such incentive. The intuition can be put more generally. To the extent a state borrows against future tax credits, it shifts the incidence of financial ruin (and therefore the monitoring incentive) from creditors to "residual" constituencies, in particular residents and voters.<sup>198</sup>

A shift toward tax-credit borrowing need not be wholesale. States could issue tax-credit debt to some but not other classes of creditors. To illustrate, suppose there are two kinds of creditors, *X* and *Y*, and an undifferentiated public, *P*. In a traditional borrowing regime, all three actors have some incentive to monitor fiscal policies, but the incentive for each is curbed by the free-rider effect. If the state begins to borrow with tax credits only, the monitoring incentive is placed squarely on *P*. If the state adopts a mixed strategy, borrowing from *X* with tax credits and from *Y* with traditional promises to pay, then the monitoring incentive shifts to *Y* and *P*. If an agency problem is the cause of excessive state debt, then placing the monitoring incentive with the best-situated constituency or constituencies could lessen the problem and reduce overall financing costs. Now suppose that *X* and *Y* correspond to dispersed foreign bondholders and union-represented domestic employees, respectively. Between the two of them, the public employees would

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197. See *supra* text accompanying notes 27–30.

198. Even more particularly, the cost of imprudent fiscal decisions falls on the owners of real property and other immovable assets.

seem to be the better monitors. Their coalition is stable and organized, and they wield voting power. If this is right, then a state might rationalize its fiscal policies by issuing tax-credit bonds coupled with traditional pension promises.

This example is meant only to be illustrative. It is not immediately obvious which creditor class or classes are best situated to monitor state debt, or whether any are better situated than the undifferentiated public. It is a difficult question because monitoring in this context requires both incentive and political power. A single foreign creditor holding, say, a billion dollars of state debt has a strong monitoring incentive, but is relatively impotent; he lacks the kind of recourse that secured creditors typically enjoy in the private debt markets. Dispersed voters have relatively little monitoring incentive, but collectively they may have the most power to discipline political actors. In the municipal context, two recent articles have argued that bondholders are better monitors than residents and therefore should bear default risk.<sup>199</sup> This may or may not be right. The argument focuses on monitoring incentives but ignores the efficacy of monitors' tools. A rigorous monitoring analysis would need to consider both incentives and power, and would need to take into account the wide variety of constituent classes. Bondholders and voters are but two of many.

One appealing attribute of tax-credit borrowing is its capacity to solve this dilemma, if only imperfectly, by allowing classes of creditors to sort themselves through trade. Suppose a state wishes to raise \$100 through borrowing, and that it elects to do so by issuing \$50 of tradable tax credits and \$50 of traditional debt. The tax-credit borrowing will offer a lower yield, to be sure, but one could conclude that rational creditors will be indifferent as between the investments because the default premium should be expected to equal the likelihood of a default times the expected loss in case of default.<sup>200</sup> Nevertheless, this presumed indifference does not hold if lenders perceive themselves as having varying degrees of political influence. The lender who believes himself relatively powerless, for whatever

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199. See Gillette, *supra* note 25, at 654–76; Richard C. Schragger, *Citizens Versus Bondholders*, 39 FORDHAM URB. L.J. 787, 789–93 (2012).

200. See Modigliani & Miller, *supra* note 29, at 288 (“[T]he cut-off point for investment . . . will be completely unaffected by the type of security used . . . . [W]e may say that regardless of the financing used, the marginal cost of capital to a firm is equal to the average cost of capital, which is in turn equal to the capitalization rate for an unlevered stream in the class to which the firm belongs.”).

reason, will be inclined to buy tax-credit bonds. On the other hand, the lender who believes herself to be relatively effective at influencing fiscal policy will choose the higher yield—traditional debt—on the theory that, with her influence, the yield implies an overstated expected cost of default. Put differently, those lenders who believe they have a relative monitoring advantage will prefer traditional debt precisely because they think they can reduce the likelihood of default relative to what one expects in a world where states issue traditional debt only.

### CONCLUSION

This Article has introduced tax-credit borrowing as a solution to one increasingly important problem of state finance: the moral hazard associated with credible threats of contagion. Widespread use of a risk-free form of debt should indeed reduce the federal government's incentive to intervene with assistance aimed at preventing the disorder and the uncertain chain reaction associated with default. To be sure, tax-credit borrowing could prove itself a kind of Maginot Line: advantage being the mother of invention, states might find other, less obvious means of externalizing risk. But in any event, the considerations this Article has outlined suggest that an *ex ante* financing solution would be more effective than *ex post* restructuring initiatives that depend on state consent, which in this context looks very much like unilateral disarmament.

Yet tax-credit borrowing may ultimately find its most valuable application in other domains. For those who doubt that risk externalization plays a significant role in excessive state debt (or even doubt that states systematically overborrow), the selective use of risk-free debt augurs very different prospects. An enlightened political class could, for example, use superpriorities to reduce the cost of borrowing from politically weak persons or classes. By placing the incidence of default on politically powerful coalitions, tax-credit borrowing could more broadly help to rationalize state finance. Or venal politicians might use superpriority borrowing to insulate favored constituencies and inefficiently *reduce* their monitoring incentives. How these dynamics would likely play out is a difficult question of political economy, and this Article has sought only to gesture in its direction. What this Article has shown, I hope, is that tax-credit borrowing offers policymakers and investors alike a chance

at greater certainty in a world where sovereign immunity still looms large.